Revised Explanatory Notes Relating to Income Tax

Published by
The Honourable Paul Martin, P.C., M.P.
Minister of Finance

December 1999

Canada

Revised Explanatory Notes Relating to Income Tax

Published by
The Honourable Paul Martin, P.C., M.P.
Minister of Finance

December 1999

Department of Finance Canada
Ministère des Finances Canada

Price: $9

Available from the Finance Canada Distribution Centre
300 Laurier Avenue West, Ottawa K1A 0G5
Tel: (613) 995-2855
Fax: (613) 996-0518

Cette publication est également disponible en français.

Cat No.: F2-97/2-1999E

ISBN-0-660-17963-6

PREFACE

These explanatory notes relate to proposed amendments to the *Income Tax Act*, the *Excise Tax Act* and another statute. These notes describe these proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable Paul Martin
Minister of Finance

These explanatory notes are provided to assist in an understanding of proposed amendments to the *Income Tax Act*, the *Excise Tax Act* and another statute. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

Table of Contents

TABLE OF CONCORDANCE

Clauses of proposed legislation

September 1999 Reference	December 1999 Reference	Income Tax Act Reference
–	1	(short title)
1	2	20
–	3	49
–	4	53
–	5	54
2	6	56
3	7	60
4	8	61.2
5	9	63
6	10	74.4
7	11	74.5
8	12	81
–	13	87
–	14	89
–	15	96
9	16	108
10	17	110.2
11	18	110.4
12	19	111
13	20	111.1
14	21	115.2
15	22	117
16	23	117.1
17	24	118
18	25	118.2
19	26	118.8
20	27	120
21	28	120.1
22	29	120.2
23	30	120.31
24	30	120.4
25	31	122.3
26	32	122.51

September 1999 Reference	December 1999 Reference	Income Tax Act Reference
–	33	122.61
27	34	125.1
28	35	126
29	36	127.4
30	37	127.5
–	38	139.1
–	38	139.2
–	39	140
–	40	141
31	41	143
32	42	146
–	43	147.4
–	44	152
–	45	156.1
33	46	160
34	47	161
35	48	161.1
36	49	163
37	50	163.2
38	51	165
39	52	180.1
40	53	190.1
41	54	204.8
42	55	204.81
43	56	204.82
44	57	204.83
45	58	204.841
46	59	204.85
47	60	206
48	61	211.7
49	62	211.8
50	63	211.9
–	64	212.2
–	65	237
51	66	239
52	67	248
53	68	250
54	69	252

September 1999 Reference	December 1999 Reference	Excise Tax Act Reference
55	70	285.1
–	71	298
56	72	327
57	73	BIA, 1999
58	–	327 (conditional)

REVISED EXPLANATORY NOTES
DECEMBER 1999

Revised Notes

The following notes relate to the 1999 federal budget proposals and are new or replace parts of those that appeared in the September 10, 1999 notes.

Clause 20

Order of Applying Provisions

ITA
111.1

Section 111.1 of the Act provides for the order in which certain deductions must be taken in computing taxable income.

This section is amended to add a reference to section 110.2 and to eliminate the reference to subsection 110.4(2), which is being repealed. For information on new section 110.2 and the repeal of section 110.4, see the commentary on those sections.

This amendment applies to the 1998 and subsequent taxation years.

Clause 21

Non-resident Funds with Canadian Service Providers

ITA
115.2

Definitions

ITA
115.2(1)

"investment turnover rate"

The "investment turnover rate" is a measure of the frequency with which a fund turns over its investments in a year. The rate is measured by a formula. All amounts referred to in the formula are expressed in the currency in which the accounts of the fund are ordinarily prepared.

The numerator, A - B, of the formula represents the excess of the amount of dispositions of investments by the fund over the amount of certain distributions by the fund to investors. In the numerator, A is the amount received by the fund during the year from dispositions of property. While property is not restricted to qualified investments, it excludes investments that are redeemed at maturity or redeemed unilaterally prior to maturity by their issuers without the consent of their holders.

The second term in the numerator, B, in the case of an investment fund includes amounts paid by the fund during the year to investors, either as distributions of the proceeds of property disposed of by the fund or on the redemption or repurchase of investors' interests in the fund. This amount is reduced by the amount of new money received by the fund from investors during the year. In the case of a pension fund, B refers to the excess for the year of benefits paid out by the fund over contributions received.

The denominator, C, of the formula is the average investments of the fund for the year, calculated at monthly valuation dates, which may be chosen by the fund.

"non-resident pension fund"

A "non-resident pension fund" is a non-resident corporation or trust of which the principal purpose is to provide pension or other employee benefits. There are two conditions for such a fund to be within the definition. First, at least 80% of the beneficiaries must be non-residents of Canada. For this purpose, only persons whose

employment activities entitle them to benefits are taken into account. Thus, the residence of persons such as spouses or dependants of the employees covered by such plans is not relevant, even though spouses and dependants may be beneficiaries in some circumstances. Second, it must not be reasonable to expect that any person will receive from the fund benefits that exceed 20% of the total value of property held by fund. This latter requirement, which parallels the 20% interest limitation in the definition "qualified non-resident fund", ensures that the fund is a pool of investments held on behalf of a number of beneficiaries.

The coming-into-force provision for this definition provides that for taxation years that end before 2002, a corporation or trust that otherwise comes within the definition, but does not meet the first condition, will still be considered a non-resident pension fund provided the funds or plans that it administers or under which it provides benefits principally relate to duties of employment performed outside Canada. This transitional rule preserves for a limited period the conditions set out in the draft version of the legislation published on September 10, 1999.

"qualified investment"

The expression "qualified investment" of a qualified non-resident fund is defined exclusively by means of a list of eligible properties.

Of the more detailed provisions, paragraph (*a*) of the definition generally includes shares and interests in partnerships, trusts, entities, funds and organizations. However, it specifically excludes shares and such interests that derive the majority of their value from real property in Canada, Canadian resource property, or timber resource property (which is defined in subsection 13(21) as referring to Canadian rights). Such shares and interests are not excluded, however, if the share or interest is listed on a prescribed stock exchange and the qualified non-resident fund (together with all persons who do not deal with the fund at arm's length) does not own 25% or more of the shares of any class or of the total value of interests in the fund. It is intended to amend the *Income Tax Regulations* (with effect from the date new section 115.2 of the Act comes into force) so that the prescribed stock exchanges will be both the Canadian exchanges listed in section 3200 of the Regulations and the foreign exchanges listed in section 3201 of the Regulations.

Paragraph (*f*) of the definition encompasses a variety of derivative financial instruments related to the properties listed in paragraphs (*a*) to (*e*), as well as, through the reference to paragraph (*f*) itself, second-order derivatives in respect of such derivatives. The definition includes options, interests, rights and forward and futures agreements in respect of the enumerated property. It also includes agreements under which obligations are derived from the price of enumerated property, such as an instrument where the return to the investor is derived from the price of a share (within the terms of paragraph (*a*)) or a commodity, or an index of such prices. Paragraph (*f*) also encompasses agreements under which obligations are derived from payments made in respect of such properties by their issuers to their holders. Examples include interest and dividend swaps. These derivative agreements are included within the definition regardless of whether they create rights or obligations regarding the referenced property (as in a commodity forward purchase contract) or not (as in an interest rate swap).

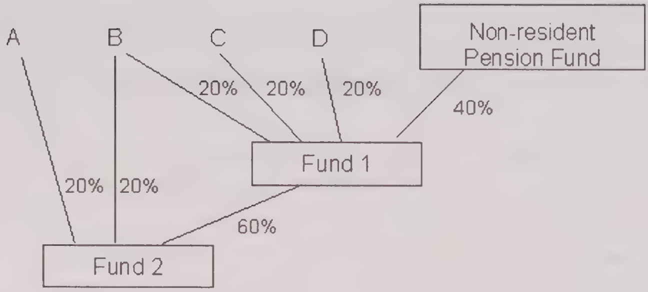
"qualified non-resident fund"

A "qualified non-resident fund" is either a non-resident pension fund, or a non-resident investment fund in which no person (other than another qualified non-resident fund) holds an interest worth more than 20% of the total value of all interests in the fund. For this purpose, holdings include both those held directly and those held indirectly through one or more intermediary entities. In applying the limitation, an interest holder is deemed to hold the interests of all holders affiliated with it.

Indirect holdings are illustrated by the following example:

EXAMPLE

(Letters designate individuals, none of whom are affiliated. Fund 1 and Fund 2 are "non-resident investment funds".)



No interest-holder in Fund 1 holds an interest worth more than 20% of the total value of interests, with the exception of Non-resident Pension Fund, which we assume qualifies as a "non-resident pension fund". As a result, Fund 1 is a "qualified non-resident fund".

No interest-holder in Fund 2 (other than Fund 1, a qualified non-resident fund) has a direct interest worth more than 20% of the total value of interests. However, in addition to B's direct interest of 20%, B has an indirect interest of 12% through Fund 1 (20% of Fund 1's 60% interest) for a total of 32%. Since the fair market value of B's direct and indirect interests exceeds 20%, Fund 2 is not a "qualified non-resident fund".

Subparagraph (*b*)(ii) of the definition provides a new non-resident investment fund up to one year to comply with the ownership interest dispersal requirement. If a non-resident fund was a qualified non-resident fund on the last day of its first fiscal period, it is deemed to be a qualified non-resident fund at any time during that period that it met the definition non-resident investment fund.

Clause 36

Labour-sponsored Venture Capital Corporations

ITA
127.4

Definitions

The third paragraph of the note for the definition "approved share" in subsection 127.4(1) of the Act is replaced by the following:

New paragraph (*b*) of the same definition excludes from the definition certain shares issued by a provincially-registered LSVCC that is not a federally-registered LSVCC. This exclusion applies only in the unusual event that, at the time of the issue of the shares, no assistance in respect of the acquisition of such shares is, because of a suspension or termination of assistance to the LSVCC under the laws of every province in which the LSVCC is registered, being provided.

Clause 48

Offset of Refund Interest and Arrears Interest

ITA
161.1

Contents of Application

ITA
161.1(3)

New subsection 161.1(3) of the Act sets out the requirements for a valid application by a corporation for an interest offset. Paragraph 161.1(3)(*a*) requires that the application specify the amount to be reallocated. While the corporation may choose the amount to be reallocated, and thus choose less than full offsetting, the amount to be reallocated may not exceed the lesser of the accumulated overpayment for the overlap period identified and the accumulated underpayment for that period. If there are, for example,

overpayments for a period in respect of more than one taxation year, each one is a separate overpayment and is offset separately, though potentially against the same underpayment.

Paragraph 161.1(3)(*b*) requires that the application specify the effective date for the reallocation. This date, which must be after 1999, may not be earlier than the later of the date from which refund interest is calculated on the overpayment amount and the date from which arrears interest is calculated on the underpayment amount. This ensures that offsetting is available only in respect of concurrent periods for which refund and arrears interest are calculated.

Paragraph 161.1(3)(*c*) requires that the application be made within 90 days of the latest of a series of dates. Subparagraphs 161.1(3)(*c*)(i) and (ii) set out dates relating to assessments giving rise to the overpayment and underpayment amounts, respectively. In each case, the relevant date is the day of mailing of the first notice of assessment giving rise to any portion of the corporation's overpayment or underpayment amount, as the case may be, to which the application relates.

EXAMPLE

Assume that the first notice of assessment for a corporation's 1999 taxation year is issued on September 1, 2000 and indicates tax payable of $10,000. If $8,000 had already been paid prior to that day the assessment would give rise to an underpayment amount of $2,000 (ignoring interest), owing since the corporation's balance-due date. As a result of a subsequent audit, a notice of reassessment is issued on February 1, 2001, indicating a revised tax payable amount of $13,000. Since no further payments have been made, the underpayment amount is thus increased to $5,000, again owing since the corporation's balance-due date for 1999. If the corporation relies on this date of reassessment as a trigger date for the 90 day period within which to apply for offsetting, it would only be such in respect of the incremental tax assessed of $3,000. That is, only the incremental $3,000 portion of the underpayment amount would be eligible for offsetting if the underpayment reassessment date were the basis for the binding time limit. An attempted offset in respect of the full $5,000 would not be valid, since the reassessment was not the first assessment giving rise to a portion ($2,000) of the amount sought to be offset,

in respect of which the 90 day period will have ended on November 30, 2000.

Subparagraphs 161.1(3)(*c*)(iii) and (iv) set out later dates where an assessment referred to in subparagraph (i) or (ii) is the subject of an objection or appeal. Subparagraph 161.1(3)(*c*)(v) deals with the situation where an overpayment has arisen without a notice of assessment having been issued. An example would be the case where an amount has been paid on account of tax, but a so-called "nil" assessment is issued, indicating that no tax is payable. In this situation, the trigger date is the day of the first notice from the Minister, such as a statement of account, indicating any portion of the balance owing to the corporation to which the application relates.

Repayment of Refund

ITA
161.1(5)

New subsection 161.1(5) of the Act applies where any portion of an accumulated overpayment amount sought to be reallocated by a corporation has been refunded to the corporation prior to the making of the reallocation. In that case, the portion of the amount reallocated that was previously refunded, and any refund interest applicable to that portion, are deemed to have become payable by the corporation on the day on which the portion was refunded. Thus, the corporation is required to repay any refunded amount that the taxpayer later applies to have reallocated.

Paragraph 161.1(5)(*b*) levies interest at the arrears rate on the reversed refund from the date it was originally paid to the corporation.

Consequential Reallocations

ITA
161.1(6)

New subsection 161.1(6) of the Act applies where any portion of a corporation's accumulated underpayment amount, against which the corporation seeks to reallocate an overpayment amount, has been paid by the corporation prior to the making of the reallocation. In this

circumstance, once the reallocation is processed, the corporation's payment will have been excessive and will create a new entitlement to a refund. If refund interest is applicable to this new amount, it is considered to be an overpayment amount. The corporation is entitled to have this consequential overpayment amount reallocated under the interest offset provision only if the corporation requests its reallocation in the application for the original reallocation. This prevents a reallocation request from becoming the first in a series of consecutive consequential reallocations.

Clause 50

Misrepresentation of a Tax Matter by a Third Party

ITA
163.2

New section 163.2 of the Act sets out the rules that apply for the purpose of applying civil penalties to third parties that make false statements or omissions in relation to tax matters.

Background information is provided below. The application of the detailed rules is more fully described in commentary following this background information. Detailed examples are provided at the end of the commentary on section 163.2.

Background

Canadian tax law includes both criminal and civil penalties that may apply to misrepresentations of tax matters to ensure that all taxpayers pay their fair share of taxes. Criminal penalties may apply where a person participates in tax evasion in respect of their or another person's taxes. Civil penalties may apply where taxpayers are shown to have knowingly, or in circumstances amounting to gross negligence, made false statements or omissions in the filing of the taxpayer's own tax information. However, Canadian tax law has not provided clear rules for assessing civil penalties for making or counselling false statements in respect of another person's tax liability. In April of 1998, the Technical Committee on Business Taxation (the "Mintz Committee") recommended that the tax law be revised to provide civil penalties against those who knowingly, or in

circumstances amounting to gross negligence, make false statements or omissions in respect of another person's tax matters.

The 1999 budget proposed to apply civil penalties to third parties who make false statements that could be used for tax purposes. In particular, two penalties were proposed, with general commentary and two examples being included in Annex 7 of the 1999 Budget Plan, which was released on February 16, 1999.

During the post-budget consultation period, concerns were expressed by professional bodies on behalf of their membership that the proposed civil penalty provisions could apply in cases where a tax professional makes an honest error of judgement, or where there is an honest difference of opinion. These concerns reflected a concern about the proposed gross negligence standard rather than the other test for liability that is based on a knowledge standard.

The gross negligence standard has been used elsewhere in the tax law and has been judicially interpreted in a number of cases. In the government's view there is a great deal of difference between "ordinary" negligence and "gross" negligence. It is not the government's policy intent to apply a third party penalty under new section 163.2 in cases of conduct that is an honest error of judgement, or an honest difference of opinion. Rather the gross negligence standard was selected because it addresses this legitimate concern while ensuring that participants in otherwise culpable activity do not escape liability.

Nevertheless, in response to representations of professional bodies, section 163.2 substitutes for "gross negligence" the concept "culpable conduct" which is defined with reference to the types of conduct to which the courts have, in the past, applied a civil penalty under the tax law. In addition, section 163.2 includes an exception for reliance in good faith that provides that a person is not considered to have acted in circumstances amounting to culpable conduct by reason only of having relied, in good faith, on information provided by the taxpayer. However, the reliance in good faith exception does not apply to a statement that a person makes in the course of an "excluded activity" as defined in subsection 163.2(1).

New section 163.2 applies to statements made after Royal Assent.

ITA
163.2(1)

New subsection 163.2(1) provides definitions that apply for the purpose of new section 163.2. The terms defined for this purpose are "culpable conduct", "entity", "excluded activity", "false statement", "gross entitlements", "participates", "person", "planning activity", "subordinate", "tax benefit" and "valuation activity". Below is more detailed commentary on some of these definitions.

"Culpable conduct" means conduct, whether an act or a failure to act, that

(a) is tantamount to intentional conduct,

(b) shows an indifference as to whether the Act is complied with, or

(c) shows a wilful, a reckless or a wanton disregard of the law.

"Excluded activity" in respect of a false statement means, generally, the activity of

(*a*) promoting or selling (whether as principal or agent or directly or indirectly) an arrangement where it can reasonably be considered that the arrangement concerns a flow-through share or a tax shelter or is an arrangement one of the main purposes for a person's participation in which is to obtain a tax benefit, or

(*b*) accepting (whether as principal or agent or directly or indirectly) consideration in respect of the sale of, or participation in, such an arrangement.

"False statement" includes a statement that is misleading because of an omission from the statement. The meaning of a "false statement" is also modified in certain cases to deem two or more false statements to be one false statement (see the commentary on new subsection 163.2(8) of the Act).

"Gross entitlements" of a person at any time, in respect of a planning activity or a valuation activity of the person, means all amounts to which the person (or another person not dealing at arm's length with

the person) is entitled, either before or after that time and either absolutely or contingently, to receive or obtain. The definition "gross entitlements" is relevant for the purpose of computing a penalty under new subsection 163.2(2) for making or furnishing a false statement in respect of tax planning arrangements. Reference should also be made to new paragraph 163.2(12)(*b*), which provides special rules that may apply in particular circumstances to exclude certain amounts from a person's gross entitlements in respect of a planning activity or a valuation activity.

Generally, "planning activity" includes organizing or creating an arrangement, entity, plan or scheme. It also includes participating (directly or indirectly) in the selling of an interest in, or the promotion of, an arrangement, entity, plan or scheme.

"Valuation activity" of a person means anything done by the person in determining the value of a property or a service.

ITA
163.2(2) and (3)

New subsection 163.2(2) provides for a penalty where a person makes or furnishes, or participates in the making of, or causes another person to make or furnish, a statement that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by another person for a purpose of the Act. The amount of the penalty is determined under new subsection 163.2(3).

Subsection 163.2(3) provides that the penalty to which a person is liable under subsection 163.2(2) in respect of a false statement is one of two amounts. The first amount applies where a false statement is made in the course of a planning activity or a valuation activity, and is the greater of $1,000 and the total of the person's gross entitlements in respect of the planning activity and the valuation activity calculated at the time at which notice of assessment of the penalty is sent to the person. In certain cases, the computation of a person's gross entitlements may be in respect of two or more false statements deemed to be one false statement (see the commentary on new subsection 163.2(8) of the Act).

The second amount is $1,000, which applies in any other case.

ITA
163.2(4) and (5)

New subsection 163.2(4) provides for a penalty where a person makes (or participates in, assents to or acquiesces in the making of) a statement to, or by or on behalf of, another person that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by or on behalf of the other person for a purpose of the Act. The amount of the penalty is determined under new subsection 163.2(5).

New subsection 163.2(5) provides that the penalty to which a person is liable under subsection 163.2(4) in respect of a false statement is the greater of two amounts. The first amount is $1,000. The second amount is the penalty to which the other person would be liable under the gross negligence penalty provision in subsection 163(2) of the Act if the other person made the statement in a return filed for the purposes of the Act and knew the statement was false. Generally, this is the amount of tax sought to be avoided, or the amount of an excess refund sought to be obtained.

ITA
163.2(6)

New subsection 163.2(6) provides an exception for reliance in good faith. This exception provides that a person who acts on behalf of the other person is not considered to have acted in circumstances amounting to culpable conduct in respect of a false statement solely because the person relied, in good faith, on information provided to the person by the other person (see subsections 163.2(2) and (4)) or, because of such reliance, failed to verify, investigate or correct the information.

ITA
163.2(7)

New subsection 163.2(7) of the Act provides that the "reliance in good faith" exception in subsection 163.2(6) does not apply in respect of a statement that a person makes (or participates in, assents to or acquires in the making of) in the course of an excluded activity. The expression "excluded activity" is defined in subsection 163.2(1).

ITA
163.2(8)

New subsection 163.2(8) provides a special rule. If applicable, subsection 163.2(8) treats two or more false statements made or furnished by a person in the course of one or more planning activities (or a valuation activity) as one false statement for the purpose of applying the penalty in subsection 163.2(2) in respect of the person's false statements. This is the case where a person's false statements were made or furnished in the course of one or more planning activities that are in respect of a particular arrangement, entity, plan, property or scheme or in the course of a valuation activity that is in respect of a particular property or service.

ITA
163.2(9)

New subsection 163.2(9) provides that a person is not considered to have participated in a planning activity or a valuation activity solely because the person provided clerical (other than bookkeeping services) or secretarial services with respect to the activity.

ITA
163.2(10) and (11)

New subsection 163.2(10) provides a special rule that applies to a false statement, as to the value of a property or service, made by a person who opines on the value of the property or service or by a person in the course of an excluded activity. A statement as to the value of a property or service is considered to be a statement that the person would reasonably be expected to know, but for circumstances amounting to culpable conduct, is a false statement if the stated value is

- less than the prescribed percentage for the property or service multiplied by the fair market value of the property or service, or

- greater than the prescribed percentage for the property or service multiplied by the fair market value of the property or service.

These two parameters provide a range in value outside of which this "reverse onus" rule will apply.

This reverse onus rule applies only where the Canada Customs and Revenue Agency (CCRA) establishes that the stated value of a property or service is outside of the range. Further, new subsection 163.2(11) provides that subsection 163.2(10) does not apply to a person in respect of a statement as to a value if the person establishes that the stated value was reasonable in the circumstances and that the statement was provided in good faith and, where applicable, was not based on one or more assumptions that the person knew or would be reasonably be expected to know, but for circumstances amounting to culpable conduct, were unreasonable or misleading in the circumstances.

The Regulations will be amended to set the prescribed percentages for the purposes of subsection 163.2(10) after the conclusion of consultations on the appropriate percentages.

In summary, where a person's statement as to the value of a property or service is within the range, the liability for a penalty under subsection 163.2(2) and (4) is to be determined under the general rule of whether the person knows, or would have known but for circumstances amounting to culpable conduct, that the statement is a false statement that could be used for a purpose under the Act. If, however, the person's statement as to the value of a property or service is established by the CCRA to be outside of the range, in order to avoid liability for the penalty the person who made the statement as to the value is to establish that the stated value was reasonable in the circumstances and that the statement was provided in good faith and, where applicable, was not based on certain unreasonable or misleading assumptions.

ITA
163.2(12) and (13)

New subsection 163.2(12) provides two rules for the purpose of applying the third party civil penalty rules in section 163.2 to a person.

First, paragraph 163.2(12)(*a*) concerns cases in which a person is assessed a penalty under subsection 163.2(2) at a particular time and another assessment of the penalty is made at a later time. If the penalty is reassessed because the gross entitlements of the person are greater at the subsequent time, the reassessment of the penalty at that

later time is considered to be a separate penalty (see new subparagraph 163.2(12)(*a*)(i)). In any other case, the notice of assessment of the earlier penalty is considered not to have been sent for the purpose of applying section 163.2 (see subparagraph 163.2(12)(*a*)(ii)). Reference should also be made to paragraph 163.2(12)(*b*), which deals with the calculation of the gross entitlements for the purpose of that later assessment.

Paragraph 163.2(12)(*b*) excludes certain amounts from a person's gross entitlements (in respect of a planning or valuation activity in which there is a false statement made or furnished by the person). In general, this rule operates to base each assessment of a penalty under subsection 163.2(2) in respect of a false statement on the gross entitlements of the person not counted in computing the amount of the person's penalty(ies) previously assessed in respect of the false statement. However, where subparagraph 163.2(12)(*a*)(ii) applies, paragraph 163.2(12)(*b*) does not apply to reduce the amount of the second assessment as the original notice of assessment is deemed not to have been sent. Thus the penalty amount on the second assessment in that case is based on the person's total gross entitlements at the time the notice of that assessment is sent.

As an example, suppose a person is assessed a penalty at a particular time under subsection 163.2(2) in the amount of $10,000, which represents the amount of the person's gross entitlements from a planning activity at that time. At a later time, it is discovered that the person's gross entitlements from the same planning activity have increased to $25,000 and another assessment of a penalty is made at that later time under subsection 163.2(2) against the person. The effect of subparagraph 163.2(12)(*a*)(i) in these circumstances is to deem the second assessment to be the assessment of a second penalty, and the effect of paragraph 163.2(12)(*b*) is to reduce the person's gross entitlements at the later time to $15,000, in order to take into account the previous assessment of $10,000. Thus the end result is that the person is liable to pay two penalties, one of $10,000 as of the particular time and another of $15,000 as of the later time.

As another example, suppose that the facts are the same as above, except that at the time of the first assessment the person's gross entitlements were $700. In that case, the person would have been assessed $1,000 under paragraph 163.2(3)(*a*) at that time. When the person is assessed at the later time, paragraph 163.2(12)(*b*) reduces

the person's gross entitlements at that later time by $1,000, the amount of the previous assessment of the penalty. As well, subparagraph 163.2(12)(*a*)(i) deems the second assessment to be the assessment of a second penalty. In these circumstances, the person would be liable to pay a penalty of $1,000 as of the particular time and would be liable to pay a second penalty of $24,000 as of the later time.

Further, new subsection 163.2(13) provides that, if an assessment of a penalty under subsection 163.2(2) or (4) is vacated, the assessment is deemed to be void.

ITA
163.2(14)

New subsection 163.2(14) provides that a person who is liable to pay a penalty under both subsections 163.2(2) and (4) in respect of the same false statement is required to pay an amount that is not more than the greater of the penalty under subsection (2) and the penalty under subsection (4).

Examples

The application of section 163.2 turns on the facts established in any particular case. The supplementary information in Annex 7 to the 1999 Budget Plan provided two examples of the application of the third party civil penalty provisions, as proposed. The following provides five additional examples in respect of applying the third party penalty rules in new section 163.2 of the Act.

Example 1: No Culpable Conduct

- Tax Professional X interprets a tax provision for Client A in a manner that could reduce Client A's tax liability.

- The interpretation concerns a matter in which bona fide uncertainty as to the application of the tax law exists, and where Revenue Canada may be expected to disagree with the interpretation.

- Tax Professional X, on A's behalf, files the related tax return based on the interpretation.

- Revenue Canada subsequently audits and reassesses Client A's tax return vis-à-vis the matter. Eventually the Supreme Court of Canada supports Revenue Canada's interpretation of the matter in respect of Client A's tax return.

- On the facts, Tax Professional X is not liable for a penalty under subsection 163.2(2) or (4) in respect of a tax planning arrangement or a tax filing that has a false statement because Tax Professional X did not know the statement was false when made and would not be reasonably expected to know, but for circumstances amounting to culpable conduct, that this was the case.

Example 2: Reliance, in good faith

- Accountant X is asked by Client A to prepare a tax return including a business financial statement to be used in the return. In response to a request by Accountant X for business related documents, Client A supplies information to Accountant X, which includes a travel expense receipt. Accountant X relies, in good faith, on this information provided by Client A and prepares the business statement that is filed with the return.

- Revenue Canada conducts a compliance audit and determines that Client A's travel expense was a non-deductible personal expense.

- Accountant X is not liable for participating in an understatement of Client A's tax liability because Accountant X

- *did not know the expense receipt was personal in nature, and*

- *would not be reasonably expected to know, but for circumstances amounting to culpable conduct, that this was the case (i.e., this is because X relied in good faith on the information provided by A).*

Example 3: Indifference as to Whether the Act is Complied With

- Accountant X has several clients that have been reassessed in respect of a tax shelter. Accountant X knows that Revenue Canada is challenging the tax effects claimed in respect of the tax shelter on the basis that the shelter is not a business, is based on a significant overvaluation of the related property and, alternatively, is technically deficient.

- The Tax Court of Canada, in a test case (formal procedure), denies deductions claimed in respect of the tax shelter in a previous year by Client B (a client of Accountant X). Client B's appeal is dismissed. The case is not appealed and Accountant X is aware of the Court's decision.

- Accountant X prepares and files a tax return on behalf of Client C that includes a claim in respect of the same tax shelter that the Tax Court determined was ineffective.

- On these facts, Accountant X would be liable for a third party penalty. However, if Accountant X had determined that there was a reasonable basis upon which the Tax Court decision could be overturned by a higher court, the penalty would not apply – see example 1.

Example 4: Wilful, Reckless or Wanton Disregard of the Law

- Taxpayer Z approaches Tax-preparer X to prepare and e-file Z's tax return. Prior to this, X (and X's firm) did not provide any services to Z and they did not know of each other.

- Taxpayer Z provides X with a T4 slip indicating that Z has $32,000 of employment income.

- Taxpayer Z advises X that he made a charitable donation of $24,000 but forgot the receipt at home. Z asks that X prepare and e-file the tax return. In fact, Z never donated anything to a charity.

- On these facts, if X were to prepare and e-file Z's return without obtaining the charitable donation receipt, X would be liable for a third party penalty. Given that the quantum of the deduction is so disproportionate to Z's apparent resources as to defy credibility, to proceed in such a manner would show an indifference as to whether the Act is complied with or would show a wilful, reckless or wanton disregard of the law.

Example 5: Tax Advocacy

- Tax preparer A knowingly counsels taxpayer T to file a false tax return.

- The CCRA conducts a review of T's tax return.

- T retains Lawyer X for the purpose of representing T with respect to the review and, if necessary, before the court.

- The CCRA auditor determines that T's tax return appears to be a false fining.

- On these facts, and subject to a CCRA Head Office Review, A could be liable for a third party penalty. T's liability for a penalty under subsection 163(2) of the Income Tax Act would depend upon whether T acted knowingly or in circumstances amounting to gross negligence with respect to the false filing. Where X acts in the normal course of providing professional representation to T, X will not be liable for a third party penalty in respect of such representation merely because X presents the facts and the law in the best possible light from T's perspective (i.e., such behaviour of X would fall outside the concept of culpable conduct).

Also, the definition "excluded activity" in subsection 163.2(1) of the Act applies to those who sell or promote a tax shelter (or a similar arrangement referred to in that definition), or accept consideration in respect of such promoting or selling activity. Unlike the definition "promoter" in subsection 237.1(1) of the tax shelter identification rules, the definition "excluded activity" does not refer to those who advise tax shelter promoters. Therefore, the reliance in good faith

> *exception in subsection 163.2(6) may be relied on by a professional advisor to a tax shelter promoter in circumstances where the advisor satisfies the good faith requirement, and does not promote, sell or accept consideration in respect of the promotion or sale of the tax shelter arrangement.*

Clause 59

Labour-sponsored Venture Capital Corporations – Dissolutions, etc.

ITA
204.85

The first paragraph of the note for subsection 204.85(3) of the Act is replaced by the following:

ITA
204.85(3)

New subsection 204.85(3) of the Act applies, for the purposes of section 127.4 and Parts X.3 and XII.5 of the Act, where there is an amalgamation or merger of corporations at least one of which is a federally-registered LSVCC or a revoked corporation. For these purposes, the new corporation is generally treated under paragraph 204.85(3)(*a*) as if it were the same corporation as, and a continuation of, each predecessor corporation. For example, the new corporation would be deemed by paragraph 204.85(3)(*a*) to have been incorporated on the date that a predecessor corporation was incorporated. Where the predecessor corporation was incorporated before March 6, 1996, it would consequently be possible for the new corporation to issue replacement shares for the shares issued by that predecessor corporation that have a 5 year holding period (rather than an 8 year holding period) and, at the same time, for the articles of the new corporation to be considered to comply with paragraph 204.81(1)(*c*) for the purposes of new paragraph 204.85(3)(*d*), described below.

Clause 70

Misrepresentation of a Tax Matter by a Third Party

ETA
285.1

New section 285.1 of the *Excise Tax Act* (ETA) sets out the rules that apply for the purpose of applying civil penalties to third parties that make, or participate in the making of, false statements or omissions in relation to tax matters. This provision parallels new section 163.2 of the *Income Tax Act* (ITA) enacted under clause 50 (see the commentary on that clause).

New section 285.1 applies to statements made after Royal Assent.

ETA
285.1(1)

New subsection 285.1(1) provides definitions that apply for the purpose of new section 285.1. The terms defined for this purpose are "culpable conduct", "entity", "excluded activity", "false statement", "gross entitlements", "participates", "planning activity", "property", "subordinate", "tax benefit", and "valuation activity". Below is more detailed commentary on some of these definitions.

"Culpable conduct" has the same meaning as in new subsection 163.2(1) of the ITA, with the exception of the reference to Part IX of the ETA. In new section 285.1 of the ETA, "culpable conduct" means conduct, whether an act or a failure to act, that

(*a*) is tantamount to intentional conduct,

(*b*) shows an indifference as to whether Part IX of the ETA is complied with, or

(*c*) shows a wilful, a reckless or a wanton disregard of the law.

"Excluded activity" in respect of a false statement means, generally, the activity of:

(*a*) promoting or selling (whether as principal or agent or directly or indirectly) an arrangement where it can reasonably be considered that one of the main purposes for a person's participation in the arrangement is to obtain a tax benefit; or

(*b*) accepting (whether as principal or agent or directly or indirectly) consideration in respect of the sale of, or participation in, such an arrangement.

"False statement" includes a statement that is misleading because of an omission from the statement. The meaning of a "false statement" is also modified in certain cases to deem two or more false statements to be one false statement (see the commentary on new subsection 285.1(8) of the Act).

"Gross entitlements" of a person at any time, in respect of a planning activity or a valuation activity of the person, means all amounts to which the person (or another person not dealing at arm's length with the person) is entitled, either before or after that time and either absolutely or contingently, to receive or obtain. The definition "gross entitlements" is relevant for the purpose of computing a penalty under new subsection 285.1(2) for making or furnishing a false statement in respect of tax planning arrangements. Reference should also be made to new paragraph 285.1(12)(*b*), which provides special rules that may apply in particular circumstances to exclude certain amounts from a person's gross entitlements in respect of a planning activity or a valuation activity.

Generally, "planning activity" includes organizing or creating an arrangement, entity, plan, or scheme. It also includes participating (directly or indirectly) in the selling of an interest in, or the promotion of, an arrangement, entity, plan, property or scheme.

"Property" is defined for the purposes of new section 285.1 to have the same meaning as in subsection 248(1) of the *Income Tax Act*.

"Tax benefit" means a reduction, avoidance or deferral of tax, net tax or other amount payable under Part IX of the ETA, or an increase in a refund or rebate under that Part.

"Valuation activity" of a person means anything done by the person in determining the value of a property or a service.

ETA
285.1(2) and (3)

New subsection 285.1(2) provides for a penalty where a person makes (or participates in the making of) or furnishes, or causes another person to make or furnish, a statement that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by another person for a purpose of Part IX of the ETA. The amount of the penalty is determined under new subsection 285.1(3).

Subsection 285.1(3) provides that the penalty to which a person is liable under subsection 285.1(2) in respect of a false statement is one of two amounts. The first amount applies where a false statement is made in the course of a planning activity or a valuation activity, and is the greater of $1,000 and the total of the person's gross entitlements in respect of the planning activity and the valuation activity calculated at the time at which notice of assessment of the penalty is sent to the person. In certain cases, the computation of a person's gross entitlements may be in respect of two or more false statements deemed to be one false statement (see the commentary on new subsection 285.1(8) of the Act).

The second amount is $1,000, which applies in any other case.

ETA
285.1(4) and (5)

New subsection 285.1(4) provides for a penalty where a person makes (or participates in, assents to or acquiesces in the making of) a statement to, or by or on behalf of, another person that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by or on behalf of the other person for a purpose of Part IX of the ETA. The amount of the penalty is determined under new subsection 285.1(5).

New subsection 285.1(5) provides that the penalty to which a person is liable under subsection 285.1(4) in respect of a false statement is the greater of two amounts. The first amount is $1,000. The second amount is 50% of the total of the understatement of net tax (or overstatement of a net tax refund) of the other person and tax payable

avoided by the other person because of the false statement, and the amount of any excess rebate claimed by the other person on the basis of the false statement.

ETA
285.1(6)

New subsection 285.1(6) provides an exception for reliance in good faith which applies for the purposes of applying the penalty provisions in subsections 285.1(2) and 285.1(4). This exception provides that a person who acts on behalf of another person is not considered to have acted in circumstances amounting to culpable conduct in respect of a false statement solely because the person relied, in good faith, on information provided to them by the other person (see subsections 285.1(2) and (4)) or, because of such reliance, failed to verify, investigate or correct the information.

ETA
285.1(7)

New subsection 285.1(7) provides that the reliance on good faith exception in subsection 285.1(6) does not apply in respect of a statement that a person makes (or participates in, assents to or acquesees in the making of) in the course of an excluded activity. The expression "excluded activity" is defined in subsection 285.1(1).

ETA
285.1(8)

New paragraph 285.1(8)(*a*) provides a special rule. If applicable, paragraph 285.1(8)(*a*) treats two or more false statements made or furnished in the course of one or more planning activities (or a valuation activity) as one false statement for the purpose of applying the penalty in subsection 285.1(2) in respect of the false statements. This is the case where the false statements were made or furnished in the course of one or more planning activities that are in respect of a particular arrangement, entity, plan, property or scheme, or in the course of a valuation activity that is in respect of a particular property or service.

For greater certainty, new paragraph 285.1(8)(*b*) provides that a "particular arrangement, entity, plan or scheme" includes one in respect of which one of the main purposes for a person's participation therein is to obtain a tax benefit (as defined in subsection 285.1(1)). Similarly, a "particular property" includes any property in respect of which one of the main purposes for a person's acquisition of that property is to obtain a tax benefit.

ETA
285.1(9)

New subsection 285.1(9) provides that a person is not considered to have participated in a planning activity or a valuation activity solely because the person provided clerical (other than bookkeeping services) or secretarial services with respect to the activity.

ETA
285.1(10) and (11)

New subsection 285.1(10) provides a special rule that applies to a false statement, as to the value of a property or service, made by a person who opines on the value of the property or service or by a person in the course of an excluded activity. A statement as to the value of a property or service is considered to be a statement that the person would reasonably be expected to know, but for circumstances amounting to culpable conduct, is a false statement if the stated value is

- less than the prescribed percentage for the property or service multiplied by the fair market value of the property or service, or

- greater than the prescribed percentage for the property or service multiplied by the fair market value of the property or service.

These two parameters provide a range in value outside of which this "reverse onus" rule will apply.

This reverse onus rule applies only where the Canada Customs and Revenue Agency (CCRA) establishes that the stated value of a property or service is outside of the range. Further, new subsection 285.1(11) provides that subsection 285.1(10) does not apply to a person in respect of a statement as to a value if the person

establishes that the stated value was reasonable in the circumstances and that the statement was provided in good faith, and, where applicable, was not based on one or more assumptions that the person knew, or would reasonably be expected to know, but for circumstances amounting to culpable conduct, were unreasonable or misleading in the circumstances.

In summary, where a person's statement as to the value of a property or service is within the range, the liability for a penalty under subsection 285.1(2) and (4) is to be determined under the general rule of whether the person knows, or would have known but for circumstances amounting to culpable conduct, that the statement is a false statement that could be used for a purpose under Part IX of the ETA. If, however, the person's statement as to the value of a property or service is established by the CCRA to be outside of the range, in order to avoid liability for the penalty the person who made the statement as to the value is to establish that the stated value was reasonable in the circumstances and that the statement was provided in good faith, and, where applicable, was not based on certain unreasonable or misleading assumptions.

ETA
285.1(12) and (13)

New subsection 285.1(12) provides two rules for the purpose of applying the third party civil penalty rules in section 285.1 to a person.

First, paragraph 285.1(12)(*a*) concerns cases in which a person is assessed a penalty under subsection 285.1(2) at a particular time and another assessment of the penalty is made at a later time. If the penalty is reassessed because the gross entitlements of the person are greater at the subsequent time, the reassessment of the penalty at that later time is considered to be a separate penalty (see new subparagraph 285.1(12)(*a*)(i)). In any other case, the notice of assessment of the earlier penalty is considered not to have been sent for the purpose of applying section 285.1 (see subparagraph 285.1(12)(*a*)(ii)). Reference should also be made to paragraph 285.1(12)(*b*), which deals with the calculation of the gross entitlements for the purpose of that later assessment.

Paragraph 285.1(12)(*b*) excludes certain amounts from a person's gross entitlements (in respect of a planning or valuation activity in which there is a false statement made or furnished). In general, this rule operates to base each assessment of a penalty under subsection 285.1(2) in respect of a false statement on the gross entitlements of the person not counted in computing the amount of the person's penalty(ies) previously assessed in respect of the false statement. However, where subparagraph 285.1(12)(*a*)(ii) applies, paragraph 285.1(12)(*b*) does not apply to reduce the amount of the second assessment as the original notice of assessment is deemed not to have been sent. Thus the penalty amount on the second assessment in that case is based on the person's total gross entitlements at the time the notice of that assessment is sent.

As an example, suppose a person is assessed a penalty at a particular time under subsection 285.1(2) in the amount of $10,000, which represents the amount of the person's gross entitlements from a planning activity at that time. At a later time, it is discovered that the person's gross entitlements from the same planning activity have increased to $25,000 and another assessment of the penalty is made at that later time under subsection 285.1(2) against the person. The effect of subparagraph 285.1(12)(*a*)(i) in these circumstances is to deem the second assessment to be an assessment of a second penalty, and the effect of paragraph 285.1(12)(*b*) is to reduce the person's gross entitlements at the later time to $15,000, in order to take into account the previous assessment of $10,000. Thus the end result is that the person is liable to pay two penalties, one of $10,000 as of the particular time and another of $15,000 as of the later time.

As another example, suppose that the facts are the same as above, except that at the time of the first assessment the person's gross entitlements were $700. In that case, the person would have been assessed $1,000 under paragraph 285.1(3)(*a*) at that time. When the person is assessed at the later time, paragraph 285.1(10)(*b*) reduces the person's gross entitlements at that later time by $1,000, the amount of the previous assessment of the penalty. As well, subparagraph 285.1(10)(*a*)(i) deems the second assessment to be the assessment of a second penalty. In these circumstances, the person would be liable to pay a penalty of $1,000 as of the particular time and would be liable to pay a second penalty of $24,000 as of the later time.

Further, new subsection 285.1(13) provides that, if an assessment of a penalty under subsection 285.1(2) or (4) is vacated, the assessment is deemed to be void.

ETA
285.1(14)

New subsection 285.1(14) provides that a person who is liable to pay a penalty under both subsections 285.1(2) and (4) in respect of the same false statement is required to pay an amount that is not more than the greater of the penalty under subsection (2) and the penalty under subsection (4).

Clause 71

Period for Assessment

ETA
298(1)(*e*)

Under paragraph 298(1)(*e*), the Minister of National Revenue is not permitted to assess a penalty more than four years after the person became liable to the penalty. This limitation does not apply to a penalty under section 280 on amounts not remitted or paid, or to a penalty under section 285 for a false statement made knowingly or under circumstances amounting to gross negligence. Paragraph 298(1)(*e*) is amended so that the limitation period also does not apply to a penalty under the third party penalty rules under new section 285.1.

Clause 72

Penalty on Conviction

ETA
327(3)

Subsection 327(3) of the ETA protects a person convicted of an offence under section 327 from being later subject to a civil penalty under section 284 (failure to provide information). This subsection is

amended to extend this protection to penalties under section 283, section 285 or new section 285.1 of the Act.

There is no longer a need for the conditional amendment for subsection 327(3) of the *Excise Tax Act* that was included in the September draft amendments. Accordingly, the note for that proposal is deleted.

Demutualization Of Insurance Corporations

Clause 3

No Disposition where Obligation Satisfied

ITA
49.1

New section 49.1 of the *Income Tax Act* clarifies that a right to a particular property is not disposed of by a taxpayer as a consequence of the acquisition of the particular property by the taxpayer in satisfaction of an absolute or contingent obligation to provide the particular property, where the obligation is pursuant to a contract or other arrangement one of the main objectives of which was to establish that right and that right was not under the terms of a trust, partnership agreement, share or debt obligation. This rule is of significance in the context of the new income tax rules for the demutualization of insurance corporations because it clarifies that there will not be any tax consequences because of the satisfaction of an undertaking to issue shares. Section 49.1 is also generally intended to apply in connection with property acquired by a taxpayer as a result of the execution of a contract.

For information about demutualizations see the commentary on new section 139.1.

This amendment applies to obligations satisfied after December 15, 1998.

Clause 4

Adjustments to Cost Base

ITA
53(1)(*d*.01)

Subsection 53(1) of the Act provides for the addition of various amounts to the adjusted cost base to a taxpayer of capital property held by the taxpayer.

New paragraph 53(1)(*d*.01) provides for an addition to a taxpayer's adjusted cost base of any amount determined under new paragraph 139.1(16)(*l*) of the Act. As explained in the commentary on subsection 139.1(16), this provision applies in respect of certain transactions associated with the demutualization of insurance corporations.

This amendment applies after December 15, 1998.

Clause 5

Capital Gains and Losses – Definitions

ITA
54

"proceeds of disposition"

The definition of "proceeds of disposition" in section 54 of the Act is relevant for the purpose of determining a taxpayer's capital gain or loss from the disposition of property. Under paragraph (*k*) of the definition, the portion of those proceeds (otherwise determined) that is deemed to be a dividend under subsection 84.1(1) or 212.1(1) of the Act is excluded from those proceeds.

Paragraph (*k*) of the definition is amended so that deemed dividends under new subsection 212.2(2) are also excluded. This amendment applies to taxation years that end after December 15, 1998.

Clause 13

Amalgamations – Continuing Corporation

ITA
87(2)(*j*.6)

Paragraph 87(2)(*j*.6) of the Act provides that a corporation formed as the result of an amalgamation is considered, for the purpose of a number of provisions of the Act, to be the same corporation as, and a continuation of, each predecessor corporation. Paragraph 88(1)(*e*.2) provides a similar continuation rule in connection with corporate windings-up to which subsection 88(1) applies.

Paragraph 87(2)(*j*.6) is amended so that it also applies for the purposes of new section 139.1, which deals with the demutualization of insurance corporations. For example, assume that a demutualizing insurance corporation issues shares to most of its policyholders and some weeks after the demutualization amalgamates with another corporation in circumstances to which subsection 87(1) applies. If shares are subsequently issued in respect of the demutualization to other policyholders (e.g., policyholders who could not be located), amended paragraph 87(2)(*j*.6) allows the tax treatment for the other policyholders to be equivalent to the tax treatment of the policyholders to whom shares were first issued on the demutualization. For more detail on the tax treatment of policyholders on demutualization, see the commentary below.

This amendment applies to amalgamations occurring, and windings-up beginning, after December 15, 1998.

Clause 14

Definitions – Paid-up Capital

ITA
89(1)

"paid-up capital"

The definition "paid-up capital" is contained in subsection 89(1) of the Act. Paragraph (*b*) of the definition defines "paid-up capital" in respect of a class of shares of the capital stock of a corporation. Subparagraph (*b*)(iii) of the definition provides that, after March 31, 1977, paid-up capital is to be calculated without reference to any provisions of the Act other than those listed in the subparagraph.

The amendment to this subparagraph adds references to new subsections 139.1(6) and (7). These provisions adjust the paid-up capital of shares issued in connection with the demutualization of an insurance corporation. For further details on demutualization, see the commentary on section 139.1.

This amendment applies after December 15, 1998.

Clause 15

Agreement or Election of Partnership Members

ITA
96(3)

Subsection 96(3) of the Act provides rules that apply if a member of a partnership makes an election under certain provisions of the Act for a purpose that is relevant to the computation of the member's income from the partnership. The election will be valid only if it is made on behalf of all the members of the partnership and the member had authority to act for the partnership.

Subsection 96(3) is amended so that it permits elections to be filed under the new provisions relating to the demutualization of insurance corporations in subsections 139.1(16) and (17).

This amendment applies to fiscal periods that end after December 15, 1998.

Clause 38

Demutualization of Insurance Corporations

ITA
139.1

New section 139.1 of the Act provides rules that apply where a mutual insurance corporation converts into a corporation with share capital -- a process referred to as "demutualization". In general terms, the rules treat policyholders as if they were shareholders participating in the reorganization of the share capital of a corporation. In particular, the rules enable policyholders to receive shares in place of their ownership interest, with no immediate tax consequences. Cash payments and other non-share benefits are generally treated as taxable corporate dividends paid by the insurer.

Section 139.1 is structured as follows:

- Subsection 139.1(1) defines expressions used in the section.

- Subsections 139.1(2) and (3) set out a number of application rules for the purposes of the section.

- Subsection 139.1(4) sets out various consequences of a demutualization, including the treatment of benefits received by policyholders pursuant to a demutualization.

- Subsection 139.1(5) sets out a special rule that applies for the purpose of determining the fair market value of an ownership right in an insurance corporation, in the context of dispositions deemed to occur under the income tax rules as a consequence of death, migration and certain other events.

- Subsections 139.1(6) and (7) contain rules relating to the paid-up capital of shares issued by an insurance corporation or a holding corporation in connection with the demutualization of the insurance corporation.

- Subsection 139.1(8) provides that certain policy dividends payable pursuant to a demutualization are not considered to be policy dividends.

- Subsection 139.1(9) deems a person who receives a demutualization benefit that is a "specified insurance benefit" to have paid a premium to the insurer.

- Subsection 139.1(10) assigns a cost to a demutualization benefit that is not a "specified insurance benefit".

- Subsection 139.1(11) excludes demutualization benefits from the application of the shareholder benefit rule in subsection 15(1).

- Subsection 139.1(12), in conjunction with subsections 139.1(13) and (14), ensures that the provision of a demutualization benefit does not produce an inappropriate result under the rules relating to RRSPs, RRIFs, DPSPs and pension plans.

- Subsection 139.1(15) contains rules that apply with respect to employee-funded group insurance policies.

- Subsections 139.1(16) and (17) contain rules allowing for the "flow-through" of demutualization benefits from a policyholder (often an employer) to an individual (often an employee of the employer).

- Subsection 139.1(18) provides, in general, that the acquisition of shares by a holding corporation of an insurance corporation on the demutualization of the insurance corporation will not be considered to result in an acquisition of control of the insurance corporation.

Section 139.1 applies to any arrangement by which the demutualization of an insurance corporation is implemented. Under one arrangement, the documents constituting the corporation would be amended to provide for share capital and shares would then be issued to policyholders (and possibly former policyholders). Another arrangement would involve the issuance of shares to a holding corporation which, in turn, would issue its shares to policyholders. A third arrangement would be to issue the shares of the insurance corporation to a holding corporation that is a mutual company

controlled by policyholders of the insurance corporation. A demutualization could also be effected by a mutual insurance corporation merging with a corporation that has share capital.

Section 139.1 applies to the demutualization of both resident and non-resident insurers, and it applies to both resident and non-resident policyholders.

Section 139.1 applies to transactions that occur after December 15, 1998.

Definitions

ITA
139.1(1)

New subsection 139.1(1) of the Act defines several expressions used in section 139.1. These definitions apply for the purposes of section 139.1 as well as sections 139.2 and 147.4.

"conversion benefit"

A "conversion benefit" is defined as a benefit that is received in connection with the demutualization of an insurance corporation because of an interest of any person in an insurance policy to which the insurance corporation has been a party. If a "conversion benefit" is a "taxable conversion benefit" (as described in the commentary below), the recipient of the benefit is generally treated under paragraph 139.1(4)(*f*) as having received a dividend from the insurance corporation. Subsections 139.1(2) and (3) set out a number of rules that determine when a benefit is considered to be received.

"deadline"

The "deadline" for a payment in respect of the demutualization of an insurance corporation is normally the end of the day that is 13 months after the time of the demutualization. Under paragraphs 139.1(2)(*a*) and (*b*) of the Act, payments (e.g., cash) in respect of a demutualization must be made before the deadline for the payment in order for the related demutualization benefit to be treated as having been received at the time of the payment rather than at the time of the undertaking to make the payment.

In certain cases, the "deadline" for a payment is extended to the latest of the following times:

- where the entire amount of the payment depends on the outcome of an initial public offering of shares of the corporation or a holding corporation in respect of the insurance corporation, the end of the day that is 60 days after the day on which the offering is completed;

- where the payment is made after the initial deadline for the payment and it is reasonable to conclude that the payment was postponed beyond that initial deadline because there was not sufficient information available 60 days before that initial deadline with regard to a person's location, the end of the day that is six months after such information becomes available; and

- a later time that is acceptable to the Minister of National Revenue.

It is expected that the Minister of National Revenue would consider requests to extend the deadline on a case by case basis. One example of where the Minister might be asked to extend the deadline for a payment is where there has been a delay in a cash payment from an insurer to a policyholder, who is an employer, due to the fact that consent to the payment is required by pension supervisory authorities.

The expression "initial deadline" in subsection 139.1(1) is defined in the same way, except that there is no deadline extension attributable to having insufficient information with regard to the location of a person. The definition "initial deadline" is relevant for the purposes of paragraphs 139.1(2)(*d*) and (*e*), which provide for relief in connection with obligations to make payments that cease.

"demutualization"

A "demutualization" is defined as the conversion of an insurance corporation from a mutual company into a corporation that is not a mutual company -- that is, into an insurance corporation with share capital, where shareholders have the voting rights and the right to the residual assets of the corporation on dissolution.

"holding corporation"

A "holding corporation" with respect to an insurance corporation is a corporation that has, in connection with the demutualization of the insurance corporation, issued shares to stakeholders and that owns shares of the insurance corporation acquired in connection with the demutualization that entitle it to 90% or more of shareholder votes. The shares of the insurance corporation may be acquired directly from the insurance corporation, or they may be acquired from the stakeholders.

"initial deadline"

This definition is discussed in the commentary on the definition "deadline".

"mutual holding corporation"

A "mutual holding corporation" in respect of an insurance corporation is a mutual company which satisfies two conditions:

- the company was established to hold shares of the capital stock of the insurance corporation; and

- the only persons entitled to vote at an annual meeting of the company are policyholders of the insurance corporation.

This expression is used in the definitions "ownership rights", "stakeholder" and "taxable conversion benefit" and in paragraph 139.1(4)(*d*) and section 139.2.

"ownership rights"

"Ownership rights" in a mutual insurance corporation are rights in respect of that corporation that are analogous to shareholder rights and are held because of an interest or former interest of any person in an insurance policy to which that corporation has been a party. Examples of ownership rights include voting rights and the right to share in the residual assets of the mutual insurance corporation on its dissolution. While ownership rights are normally held by policyholders, a demutualization may involve the transfer of ownership rights to a holding corporation as a preliminary step to the

issuance of shares by the insurance corporation. "Ownership rights" in a mutual insurance corporation are also defined to include any contingent or absolute right to receive a benefit in connection with the demutualization of that corporation. Under paragraphs 139.1(4)(*a*) and (*d*), shares acquired in exchange for ownership rights or for the alteration or dilution of ownership rights are received on a rollover basis at a deemed cost of nil.

A mutual holding corporation holds the shares of the capital stock of an insurance corporation. "Ownership rights" in respect of the mutual holding corporation are held because of the interest of any person in an insurance policy to which the insurance corporation is a party. "Ownership rights" in respect of a mutual holding corporation are referred in paragraph (*c*) of the definition "taxable conversion benefit" and paragraph 139.1(4)(*d*). These rights would normally include the right to vote at meetings of the mutual holding corporation and the right to share in the residual assets of the mutual holding corporation on its dissolution.

"person"

A "person" is defined to include a partnership.

"share"

A "share" of the capital stock of a corporation is defined to include a right granted by the corporation to acquire a share of its capital stock. It is intended to include a right of a contingent nature.

"specified insurance benefit"

This definition is discussed in the commentary on subsection 139.1(9).

"stakeholder"

The expression "stakeholder" is defined with reference to the demutualization of an insurance corporation. A "stakeholder" is a person entitled to a conversion benefit in connection with the demutualization, other than a holding corporation or a mutual holding corporation. The expressions "holding corporation" and "mutual holding corporation" are also defined in subsection 139.1(1).

"taxable conversion benefit"

A "taxable conversion benefit" is any "conversion benefit" (described in the commentary above) received by a stakeholder in connection with the demutualization of an insurance corporation, other than certain excluded conversion benefits. Under paragraph 139.1(4)(*f*), the receipt by a stakeholder of a taxable conversion benefit is generally treated as a deemed dividend received by the stakeholder. Benefits excluded for this purpose are:

- shares of the insurance corporation;
- shares of a holding corporation in connection with the demutualization; and
- ownership rights in a mutual holding corporation in respect of the insurance corporation, as described in the commentary on the definition "ownership rights".

By virtue of the definition of "share" in subsection 139.1(1), rights to acquire shares are also excluded from being taxable conversion benefits.

The following, if provided in connection with the demutualization of an insurance corporation, are examples of taxable conversion benefits:

- a cash payment;
- a policy dividend (see the commentary on paragraphs 139.1(3)(*c*) to (*f*) and subsection 139.1(8));
- an enhancement of benefits under an insurance policy;
- a new insurance policy; and
- a reduction in future premiums under an insurance policy (see the commentary on paragraph 139.1(3)(*b*)).

A taxable conversion benefit may also include payments received in lieu of dividends on shares. For example, shares may not be issued to policyholders who cannot be located. Alternatively, shares may be issued and then cancelled if the policyholder cannot be tracked down.

In either case, a policyholder who is subsequently located could receive a payment on account of missed dividends. The entitlement to this type of payment would generally be expected to be described in disclosure materials provided in respect of a demutualization. In these circumstances, it is intended that such payments be treated as taxable conversion benefits.

Rules of General Application

ITA
139.1(2)(*a*) and (*b*)

New paragraphs 139.1(2)(*a*) and (*b*) of the Act contain rules that apply where a corporation becomes obligated (absolutely or contingently) to make or arrange a payment in providing a benefit in respect of a demutualization. These rules are relevant where taxable conversion benefits are provided on the demutualization of an insurance corporation. They are necessary because there are two transactions which might otherwise be considered to give rise to the receipt of benefits: the undertaking of an obligation to provide benefits, and the payment pursuant to the obligation.

Paragraphs 139.1(2)(*a*) and (*b*) specify when the benefit received consists of the undertaking of the obligation to make the payment, and when it consists of the actual payment. They apply, together with paragraphs 139.1(2)(*h*) and (*j*), to determine when a taxable conversion benefit is considered to be received and the value of the benefit. Where the undertaking of an obligation constitutes the benefit, the benefit is generally considered to be received at the time of demutualization, and its value is its fair market value at that time. Where the making of a payment constitutes the benefit, the benefit is considered to be received when the payment is made, and the value of the benefit is equal to the amount of the payment.

Where, in connection with a demutualization, a corporation becomes obligated to make or arrange a payment, the benefit is generally considered under paragraph 139.1(2)(*a*) to consist of the undertaking of the obligation and not of the making of the payment. The obligation may be of an absolute or contingent nature. In the event that this obligation results in the deemed receipt under paragraph 139.1(4)(*f*) by a taxpayer of a dividend as of the time of the

demutualization, the corporation must report the deemed receipt of the dividend to the Canada Customs and Revenue Agency.

Paragraph 139.1(2)(*a*) is subject to the rule in paragraph 139.1(2)(*b*), described below, and to the rules in paragraphs 139.1(2)(*c*) to (*g*). It is intended that potential reporting obligations pursuant to paragraph 139.1(2)(*a*) will be suspended in the period during which it is reasonable to consider that paragraph 139.1(2)(*b*) or (*d*) may ultimately override the application of paragraph 139.1(2)(*a*). In addition, reporting obligations may be eliminated or delayed because of the operation of paragraphs 139.1(2)(*c*) to (*g*).

Except as noted below, paragraph 139.1(2)(*b*) applies where, before the "deadline" for the payment (as defined in subsection 139.1(1)), a corporation makes a payment in connection with the demutualization. In this case, the benefit consists of the making of the payment and not the undertaking of the obligation to make or arrange the payment. Paragraph 139.1(2)(*b*) does not apply with respect to benefits payable (other than policy dividends) under an insurance policy in connection with a demutualization. For example, if the amount payable under life insurance policies is increased in connection with a demutualization, paragraph 139.1(2)(*b*) will not apply to any payments made pursuant to the increase. Paragraph 139.1(2)(*a*) will therefore apply, and the benefit will consist of the policy improvements. These improvements will have to be valued for the purpose of determining the amount of the taxable conversion benefit. In addition, paragraph 139.1(2)(*b*) is subject to paragraphs 139.1(2)(*f*) and (*g*), as described below.

EXAMPLE

The following example illustrates the application of paragraphs 139.1(2)(a) and (b), in respect of a policyholder whose location is known to an insurer. Assume that, in connection with its demutualization, an insurer undertakes to pay an extraordinary policy dividend. (For more detail on the distinction between extraordinary policy dividends, in connection with a demutualization, and normal policy dividends, see the commentary on paragraph 139.1(3)(c)). If the extraordinary dividend is paid to a particular policyholder within 13 months after the demutualization, the policyholder will be considered to have received a taxable conversion benefit when the dividend is paid.

> *If the dividend is payable to another policyholder more than 13 months after the demutualization, that policyholder's taxable conversion benefit will consist of the right, which may be contingent, to receive the dividend (assuming that the Minister of National Revenue has not extended the 13-month period during which paragraph 139.1(2)(b) applies). In this case, whether or not the dividend is ultimately paid, the policyholder will be considered to have received a taxable conversion benefit.*

ITA
139.1(2)(*c*) to (*g*)

New paragraphs 139.1(2)(*c*) to (*g*) of the Act provide additional exceptions with regard to the general rule in paragraph 139.1(2)(*a*) that a demutualization benefit is considered to consist of an undertaking to make a payment rather than the payment itself.

Paragraph 139.1(2)(*c*) applies where policyholders cannot be located by insurers. For the purposes of the demutualization rules, no benefit is considered to have been received as a consequence of the undertaking of an absolute or contingent obligation of a corporation to make or arrange a payment (other than a payment, made pursuant to the terms of an insurance policy, that is not a policy dividend) unless it is reasonable to conclude that there is sufficient information, with regard to the location of a person, to make or arrange the payment.

Paragraph 139.1(2)(*d*) applies in the event that a stakeholder to whom an undertaking has been provided in connection with a demutualization does not receive any payment pursuant to the undertaking and the undertaking expires before the initial deadline for the payment (as defined in subsection 139.1(1)). Where this is the case, the stakeholder will not be subject to tax in respect of the undertaking. Paragraph 139.1(2)(*d*) does not, however, apply in connection with an undertaking of an obligation to make or arrange a payment pursuant to the terms of an insurance policy, unless the payment was to be a policy dividend.

Paragraph 139.1(2)(*e*) applies in the unusual event that paragraph 139.1(2)(*a*) would otherwise apply to an obligation and the reason that paragraph 139.1(2)(*d*) does not extend relief is that the relevant obligation was still outstanding at the time of the initial deadline.

Where this is the case, no benefit is considered to have been received because of the undertaking of an obligation to make or arrange a payment (i.e., the stakeholder is not subject to tax in respect of the obligation) if:

- it is reasonable to conclude that there was not, before the initial deadline for the payment, sufficient information with regard to the location of a person to make or arrange the payment; and

- such information becomes available on a particular day after the initial deadline and the obligation ceases not more than six months after the particular day.

Paragraph 139.1(2)(*f*) applies where, in connection with a demutualization, there is an undertaking of an obligation to make annuity payments through the issuance of an annuity contract to supplement benefits provided either under a retirement annuity referred to in subsection 147.4(1) or paragraph 254(*a*) or under a group annuity contract that was issued under a registered pension plan that has been wound up. In these circumstances, no benefit is considered to have been received in connection with the demutualization either as a consequence of the undertaking of the obligation or as a consequence of the making of the supplemental annuity payments. The supplemental payments will instead be included in computing the recipient's income under paragraph 56(1)(*d*).

Paragraph 139.1(2)(*g*) applies where an annuity contract referred to in subsection 147.4(1) or paragraph 254(*a*) of the Act is amended, or replaced with another annuity contract, and the purpose of the amendment or replacement is to enhance benefits in connection with a demutualization. (The amendments to subsections 147.4(2) and (3) ensure that this can occur without any adverse tax consequences.) Paragraph 139.1(2)(*g*) provides that, where such an amendment or replacement occurs, no benefit is considered to have been received in connection with the demutualization. These transactions will instead be reflected in higher payments of retirement income which, as a result of the application of section 147.4 or paragraph 254(*a*), will be included in computing the recipient's income under paragraph 56(1)(*a*) of the Act.

ITA
139.1(2)(*h*)

New paragraph 139.1(2)(*h*) of the Act specifies the time at which a stakeholder is considered to receive a taxable conversion benefit in connection with the demutualization of an insurance corporation. This paragraph is relevant primarily for paragraph 139.1(4)(*f*), which sets out the tax treatment of taxable conversion benefits.

ITA
139.1(2)(*i*)

Several provisions in section 139.1 of the Act refer to the time at which an insurance corporation demutualizes. New paragraph 139.1(2)(*i*) provides that this time is generally the time at which the insurance corporation first issues a share of its capital stock.

Paragraph 139.1(2)(*i*) also contemplates the possibility that an insurance corporation could issue non-voting shares of its capital stock before demutualization, in which case it could remain a mutual company until demutualization. The issuance of these shares is ignored for the purpose of determining the time of demutualization.

ITA
139.1(2)(*j*)

Under paragraph 139.1(4)(*f*) of the Act, the tax treatment of a taxable conversion benefit is based on the value of the benefit. New paragraph 139.1(2)(*j*) provides that the value of a benefit is the fair market value of the benefit at the time it is received by the stakeholder. Except as otherwise provided by paragraph 139.1(3)(*b*), paragraph 139.1(2)(*h*) specifies the time at which a stakeholder is considered to receive a taxable conversion benefit.

Special Cases

ITA
139.1(3)(*a*)

New paragraph 139.1(3)(*a*) of the Act applies where benefits are enhanced under an insurance policy in connection with the demutualization of an insurance corporation. The enhancement is

considered to be a benefit that is received by the policyholder. This rule clarifies that the taxable conversion benefit resulting from a policy enhancement is a benefit of the policyholder even though, for example, any payment pursuant to the enhancement may be made to another person. Paragraph 139.1(3)(*a*) is intended to apply to all policy enhancements, whether implemented by policy amendment, by the addition of riders, or in any other way. However, it does not apply if the benefit enhancement is under an annuity contract referred to in subsection 147.4(1) or paragraph 254(*a*) of the Act. Under these circumstances, new paragraph 139.1(2)(*g*) provides that no demutualization benefit is considered to have been received as a consequence of the benefit enhancement.

ITA
139.1(3)(*b*)

New paragraph 139.1(3)(*b*) of the Act contains rules that apply where premiums payable under an insurance policy are reduced in connection with the demutualization of an insurance corporation. It is intended to ensure that a reduction in premiums is considered to be a single benefit, rather than a series of benefits that are provided each time the policyholder pays a reduced amount of premium. The rules provide that the policyholder is, in these circumstances, deemed to receive a benefit equal to the present value (at the time of demutualization) of the additional premiums that would otherwise be payable. The present value would be determined taking into account the probability that the policy will be in existence on each premium payment date.

ITA
139.1(3)(*c*) to (*f*)

New paragraph 139.1(3)(*c*) of the Act provides that a policy dividend is considered to be provided in connection with a demutualization only to the extent that

- the demutualization proposal sent to stakeholders refers to the dividend,
- the payment of the dividend is contingent on stakeholder approval for the demutualization, and

- the dividend was not paid pursuant to an undertaking given to ensure that the demutualization would not have an adverse impact on policy dividends.

The purpose of paragraph 139.1(3)(*c*) is to provide an administratively workable distinction between normal policy dividends, on the one hand, and extraordinary policy dividends payable in connection with a demutualization. For detail on the differences in tax treatment flowing from this distinction, see the commentary for subsection 139.1(8).

Paragraph 139.1(3)(*c*) also applies to undertakings to pay policy dividends. An undertaking is considered to be provided in connection with a demutualization only to the extent that the undertaking is to pay a dividend that meets the requirements described above.

The reason for paragraph 139.1(3)(*c*) applying to both policy dividends and undertakings to pay policy dividends is that, in some cases, the payment of a dividend constitutes the conversion benefit while in other cases it is the undertaking to pay the dividend that is the benefit. For additional information in this regard, see the commentary on paragraphs 139.1(2)(*a*) and (*b*).

New paragraph 139.1(3)(*d*) contains a rule that applies if only part of a policy dividend is a benefit provided in connection with a demutualization. It deems that part of the policy dividend to be a separate dividend from the other part of the policy dividend. This rule is relevant for subsection 139.1(8), which provides that a policy dividend is not treated as such (other than for the purposes of section 139.1) if the payment of the dividend is a taxable conversion benefit.

New paragraph 139.1(3)(*e*) of the Act clarifies that a reference to a policy dividend includes an amount that is in lieu of payment of, or in satisfaction of, a policy dividend.

New paragraph 139.1(3)(*f*) clarifies that the payment of a policy dividend includes the application of a policy dividend to pay premiums or to repay a policy loan. If a policy dividend is applied as described above (or is otherwise paid) within 13 months after the demutualization, paragraph 139.1(2)(*b*) and subsection 139.1(8) generally ensure that the policy dividend is not treated as such, other

than for the purposes of section 139.1. As a consequence, paragraph 148(2)(*a*) would not apply in these circumstances.

ITA
139.1(3)(*g*)

New paragraph 139.1(3)(*g*) of the Act applies where an insurance corporation demutualizes by merging with one or more other corporations. The corporate entity formed by the merger is deemed, for the purposes of section 139.1, to be the same corporation as, and a continuation of, the mutual insurance corporation. This rule applies regardless of where the insurance corporation is resident.

ITA
139.1(3)(*h*)

New paragraph 139.1(3)(*h*) of the Act applies where one insurance corporation has, at any time, assumed (or has otherwise become responsible for) the liabilities of another insurer under an insurance policy. For the purposes of section 139.1, the first-mentioned insurer is considered to have become a party to the policy.

ITA
139.1(3)(*i*)

New paragraph 139.1(3)(*i*) of the Act applies to cases where an insurer sends a cheque (or other means of payment) to an address and it is returned without being received by the addressee. In these circumstances, it is deemed not to have been sent.

Consequences of Demutualization

ITA
139.1(4)

New subsection 139.1(4) of the Act sets out many of the tax consequences that apply where an insurance corporation demutualizes.

ITA
139.1(4)(*a*)

New paragraph 139.1(4)(*a*) of the Act provides that the disposition, alteration or dilution of ownership rights in connection with the demutualization of an insurance corporation does not give rise to any gain or loss.

Paragraph 139.1(4)(*a*) would apply, for example, where stakeholders receive shares of the insurance corporation or of a holding corporation on the extinguishment of their ownership rights. It would also apply to the transfer of ownership rights by stakeholders to a holding corporation in return for shares of the holding corporation, and to the subsequent surrender of those rights by the holding corporation for shares of the insurance corporation.

ITA
139.1(4)(*b*)

New paragraph 139.1(4)(*b*) of the Act clarifies that an amount paid or payable to a stakeholder in connection with the disposition, alteration or dilution of the stakeholder's ownership interest is not an eligible capital expenditure. This amount is intended not to be deductible in computing the payer's income.

ITA
139.1(4)(*c*)

New paragraph 139.1(4)(*c*) of the Act provides that an election cannot be made under subsection 85(1) or (2) of the Act in respect of the disposition of ownership rights in connection with the demutualization of an insurance corporation. The rules in subsection 139.1(4) are expected to achieve substantially the same result as elections under those subsections, without the need for any elections to be filed.

ITA
139.1(4)(*d*)

New paragraph 139.1(4)(*d*) of the Act applies where, in connection with the demutualization of an insurance corporation, a person acquires shares of the corporation, or of a holding corporation, for consideration that includes the transfer, surrender, alteration or dilution of ownership rights in the insurance corporation. Paragraph 139.1(4)(*d*) provides that the shares have a cost of nil to the person. The paragraph is not limited to stakeholders. It would apply if a holding corporation acquires ownership rights from stakeholders and then surrenders the rights.

Paragraph 139.1(4)(*d*) also applies with respect to the cost of a right granted by the insurance corporation, or the holding corporation, to acquire a share of the corporation. This follows from the expanded definition of "share" in subsection 139.1(1).

If an insurance corporation issues shares to its stakeholders in return for the surrender of their ownership rights, and the stakeholders subsequently transfer the shares to a holding corporation in exchange for shares of the holding corporation, paragraph 139.1(4)(*d*) will not apply with respect to the acquisition of shares from the holding corporation. Only the first transaction involves an acquisition of shares for consideration that includes the surrender of ownership rights.

Paragraph 139.1(4)(*d*) also applies where, in connection with a demutualization, a stakeholder acquires ownership rights in a mutual holding corporation. These ownership rights are deemed to have a cost of nil. For additional information, see the commentary on the definition "ownership rights" in subsection 139.1(1).

ITA
139.1(4)(*e*)

New paragraph 139.1(4)(*e*) of the Act applies where a demutualization is effected by having an insurance corporation issue shares to a holding corporation and the holding corporation issue its own shares to stakeholders. The paragraph deems the cost of the shares of the insurance corporation acquired by the holding corporation to be nil.

ITA
139.1(4)(*f*)

New paragraph 139.1(4)(*f*) of the Act sets out the tax treatment of a taxable conversion benefit received at any time by a stakeholder in connection with the demutualization of an insurance corporation. It provides that the corporation that conferred the benefit (i.e., generally the insurance corporation or a corporation holding the shares of the insurance corporation) is considered to have paid, and the stakeholder is considered to have received, a dividend at that time on shares of that corporation in an amount equal to the value of the benefit. The rules in the Act applicable to corporate dividends will therefore apply with respect to the benefit. In certain cases where the insurer is non-resident, paragraph 139.1(4)(*g*) deems the insurer to be a resident corporation and a taxable Canadian corporation with respect to the dividend.

New paragraph 139.1(4)(*f*) does not, however, apply in circumstances to which subsection 139.1(14) applies. See, in this regard, the commentary on subsection 139.1(14).

Subsection 139.1(2) contains rules regarding the time at which a benefit is considered to be received and the determination of the value of the benefit. For a description of the rules, see the commentary on that subsection.

ITA
139.1(4)(*g*)

New paragraph 139.1(4)(*g*) of the Act applies where a non-resident insurer confers a taxable conversion benefit on a stakeholder. It also applies where conversion benefits are flowed through to employees and others, as contemplated by subsection 139.1(16). For the purposes of Part I of the Act, any resulting dividend is deemed to be paid by a taxable Canadian corporation that is resident in Canada. As a consequence, if the stakeholder is a resident individual, the dividend gross-up and tax credit mechanism will apply. If the stakeholder is a resident corporation, the inter-corporate dividend deduction will generally be available, and Part IV tax may apply. However, paragraph 139.1(4)(*g*) does not apply if a deduction under section 126 of the Act in respect of any foreign tax on the dividend is claimed.

ITA
139.1(4)(*h*)

New paragraph 139.1(4)(*h*) of the Act applies for the purpose of deemed dispositions under the Act on death (section 70) and migration (section 128.1) and with respect to trusts (subsection 104(4)). The fair market value of rights to benefits is, before the time (determined under paragraph 139.1(2)(*h*)) that the benefits are received, deemed to be nil. The purpose of this rule is to minimize the administrative difficulties associated with the valuation of such rights. Paragraph 139.1(4)(*h*) should be read together with subsection 139.1(5).

ITA
139.1(4)(*i*)

New paragraph 139.1(4)(*i*) of the Act applies where a person acquires an annuity contract in respect of which, because of new paragraph 139.1(2)(*f*), no demutualization benefit is considered to have been received. In these circumstances, the cost of the annuity contract is deemed to be nil. This ensures that no deduction may be claimed under paragraph 60(*a*) of the Act in respect of annuity payments from the contract. In addition, the accrual rules for annuity contracts in section 12.2 of the Act do not apply.

Fair Market Value of Ownership Rights

ITA
139.1(5)

New subsection 139.1(5) of the Act applies where an insurance corporation makes, at any time, a public announcement that it intends to seek approval for its demutualization. For the purposes of section 70, subsection 104(4) and section 128.1 of the Act, the fair market value of ownership rights in the corporation is deemed to be nil throughout the period that

- begins at that time, and

- ends either at the time of the demutualization or, in the event that the corporation makes, at any subsequent time, a public

announcement that it no longer intends to demutualize, at that subsequent time.

Paid-up Capital – Insurance Corporation

ITA
139.1(6)

New subsection 139.1(6) of the Act sets out rules that apply to the determination of the paid-up capital of shares of an insurance corporation resident in Canada that has demutualized. The purpose of the subsection is to prevent stakeholders from being deemed by subsection 84(1) to receive dividends because of an increase in stated capital on the issuance of shares as a conversion benefit. Instead, a deemed dividend will arise at the time, if ever, that the shares are redeemed or acquired by the insurance corporation.

Paragraph 139.1(6)(*a*) deducts from the paid-up capital of a class of shares of the insurer the total amount that subsection 84(1) of the Act would, if paragraph 139.1(6)(*a*) were not applicable, deem to have been paid as dividends on shares of that class in connection with the demutualization. Subsection 84(1) deems a dividend to have been paid when the paid-up capital of a class of shares is increased, other than in specified ways. For example, if surplus or other amounts are converted to stated capital on the demutualization of the insurer, paragraph 139.1(6)(*a*) will deduct a corresponding amount from paid-up capital.

Paragraph 139.1(6)(*b*) provides for an addition to the paid-up capital of a class of shares where paragraph 139.1(6)(*a*) has reduced the paid-up capital of the class. The amount that is added at any time is equal to the total dividends deemed by subsections 84(3), (4) and (4.1) of the Act to have been paid on shares of the class before that time minus the dividends that would have been deemed to have been paid if subsection 139.1(6) had not applied to the class of shares. In other words, paragraph 139.1(6)(*b*) reverses the reduction in paid-up capital to the extent that additional deemed dividends have arisen because of the reduction.

EXAMPLE

On its demutualization, Insurance Co. issues 100 shares to each of its 1,000 policyholders and adds $1 million to its stated capital. Subsequently, Insurance Co. redeems 40,000 shares for $14 per share. What is the paid-up capital of that class of shares after the redemption of the shares?

Without reference to subsection 139.1(6), the paid-up capital would be $600,000 ($1 million – (40,000 x $10)). Paragraph 139.1(6)(a) requires $1 million to be subtracted in computing paid-up capital, which means that there is a total deemed dividend of $560,000 (i.e., 40,000 x $14) to shareholders. If the $1 million had not been subtracted, the deemed dividend would have been only $160,000 (i.e., 40,000 x ($14 - $10)). Consequently, the paid-up capital after the redemption is nil ($600,000 - 1,000,000 + (560,000 - 160,000)).

Paid-up Capital – Holding Corporation

ITA
139.1(7)

New subsection 139.1(7) of the Act sets out rules that apply to the determination of the paid-up capital of shares of a particular corporation resident in Canada that has been a holding corporation that acquired shares of an insurance corporation from the insurance corporation on its demutualization.

The rules in subsection 139.1(7) are the same as the rules in subsection 139.1(6), except for the specification of the amount to be deducted from paid-up capital. The amount deducted from the paid-up capital of a class of shares is equal to the total amount by which the paid-up capital of the class would, but for subsection 139.1(7), increase as a result of the holding corporation's acquisition of shares of the insurance corporation on its demutualization.

The reference in subsection 139.1(7) to the acquisition of shares on the demutualization of the insurer is intended to refer only to the initial acquisition of shares as part of the transaction whereby the insurer ceases to be a mutual insurance corporation. This acquisition would not involve the holding corporation paying any consideration

to the insurer for the shares. Subsection 139.1(7) is not intended to apply where the holding corporation acquires shares for full consideration payable to the insurer, even though this might occur as part of the same series of transactions as the demutualization.

Policy Dividends

ITA
139.1(8)

New subsection 139.1(8) of the Act provides that if the payment of a policy dividend is a taxable conversion benefit, the policy dividend is deemed, for the purposes of the Act (other than section 139.1 itself), not to be a policy dividend. Consequently, the rules in section 148 that apply in respect of policy dividends will not apply. Subsection 139.1(8) also provides that the insurer may not include an amount in respect of the policy dividend in computing its deductible reserves. Such policy dividends are generally treated as corporate dividends pursuant to paragraph 139.1(4)(*f*).

In determining the treatment of policy dividends under section 139.1, several provisions must be considered. Paragraphs 139.1(2)(*a*) and (*b*) contain rules for determining whether a conversion benefit consists of an obligation (whether absolute or contingent) of the insurer to make a payment, or the payment itself. Subsection 139.1(8) applies with respect to a policy dividend only if the payment of the dividend is the benefit, i.e., only if paragraph 139.1(2)(*b*) applies. In general, these are dividends that are paid within 13 months after the demutualization. Paragraph 139.1(3)(*c*) specifies which policy dividends are considered to be paid in connection with a demutualization. Paragraph 139.1(3)(*d*) splits a policy dividend into two separate dividends where only part of the dividend is paid because of the demutualization. Paragraphs 139.1(3)(*e*) and (*f*) clarify the circumstances in which a policy dividend is considered to be paid.

Payment and Receipt of Premium

ITA
139.1(9)

New subsection 139.1(9) of the Act provides that if, in connection with the demutualization of an insurance corporation, a person receives a taxable conversion benefit that is a specified insurance benefit, the person is deemed to have paid a premium equal to the value of the benefit. The premium is considered to have been received by the insurer that is obligated to pay benefits under the policy to which the benefit relates. (For this purpose, an assumption of a particular insurer's obligation to pay benefits by another insurer is considered to remove the obligation to pay those benefits by the particular insurer.)

The payment date for the premium is the time of demutualization, which is generally stated by paragraph 139.1(2)(*i*) to be the time the insurer first issues a share. Pursuant to paragraphs 139.1(2)(*h*) and (*j*), the value of the specified insurance benefit is generally its fair market value at the time of demutualization.

The combined effect of subsection 139.1(9) and paragraph 139.1(4)(*f*) is to treat a stakeholder and the insurer as if the insurer had paid a corporate dividend to the stakeholder at the time of demutualization, which the stakeholder immediately paid as a premium under an insurance policy.

Under subsection 139.1(1), a "specified insurance benefit" is a taxable conversion benefit provided by the demutualizing insurer that is

- an enhancement of benefits under an insurance policy,
- an issuance of an insurance policy,
- an undertaking by the insurer of an obligation to pay a policy dividend, or
- a reduction in the premiums payable under an insurance policy.

Paragraphs 139.1(2)(*a*) and (*b*) specify when an undertaking to pay a policy dividend constitutes the benefit for purposes of section 139.1

and when the actual payment of the dividend is the benefit. Generally, the undertaking will be the benefit if the dividend is payable more than 13 months after demutualization. A "specified insurance benefit" includes taxable conversion benefits that are undertakings to pay policy dividends. It does not include taxable conversion benefits that consist of the payment of policy dividends.

Subsection 139.1(9) also applies to insurance corporations in connection with each benefit that is not received by a person as a "specified insurance benefit" because of the application of paragraph 139.1(2)(*f*) or (*g*). These paragraphs apply, in certain cases, in connection with the issuance of annuity contracts and the enhancement of benefits under annuity contracts. Without affecting the treatment of persons enjoying such benefits, the insurance corporation obligated to pay benefits under such an annuity contract is deemed to have received a premium at the time of the demutualization equal to the value of the benefit associated with the issuance or enhancement of the annuity contract. For additional information on the tax treatment of the person enjoying such benefits, see the commentary on paragraphs 139.1(2)(*f*), (2)(*g*) and (4)(*i*).

The effect of the rules in subsection 139.1(9) for stakeholders is overriden for certain purposes in the event that paragraph 139.1(15)(*e*) applies. Paragraph 139.1(15)(*e*) applies in certain cases where a stakeholder (typically an employer) receives a conversion benefit because of the stakeholder's interest in a group insurance policy the full cost of which was borne by employees. Where subsection 139.1(15) applies to a premium deemed to be paid by subsection 139.1(9), the stakeholder is deemed not to have paid the premium for the purposes of paragraph 6(1)(*f*) and regulations made for the purpose of subsection 6(4). This typically results in more favourable tax treatment for the employees.

Cost of Taxable Conversion Benefit

ITA
139.1(10)

New subsection 139.1(10) of the Act applies where a stakeholder receives a taxable conversion benefit that is not a "specified insurance benefit", as described above. Where this is the case, the stakeholder is deemed to have acquired the benefit at a cost equal to the value of

the benefit. Pursuant to paragraph 139.1(2)(*j*), the value of the benefit is its fair market value at the time the stakeholder is considered to receive the benefit. This time is determined under paragraph 139.1(2)(*h*).

No Shareholder Benefit

ITA
139.1(11)

New subsection 139.1(11) of the Act provides that subsection 15(1) does not apply to a conversion benefit. Subsection 15(1) includes in income certain benefits conferred by a corporation on a shareholder or on a person in contemplation of the person becoming a shareholder. The purpose of subsection 139.1(11) is to ensure that the issuance of shares or rights to acquire shares in connection with a demutualization is not treated as a shareholder benefit to which subsection 15(1) applies.

Rules for Various Retirement Savings Vehicles

ITA
139.1(12) to (14)

New subsections 139.1(12) to (14) of the Act provide rules for various retirement savings vehicles.

Subsection 139.1(12) of the Act generally provides that the receipt of a conversion benefit shall, for the purposes of the provisions of the Act that relate to the deductibility of contributions, and the taxation of distributions, under RRSPs, RRIFs, deferred profit sharing plans, retirement compensation arrangements and superannuation or pension funds or plans, be considered neither a contribution to, nor a distribution from, such a plan or fund. This subsection does not, however, affect the tax treatment of premiums deemed to be paid in respect of such a plan or fund because of the application of paragraph 139.1(9)(*c*).

In addition, where a trust that governs any such plan or fund holds an interest in a life insurance policy, subsection 139.1(12) does not apply in the event that a demutualization benefit is received because of the interest unless the benefit is received by the trust itself. Unless the

benefit is received by the trust itself, subsection 139.1(14) provides that the demutualization benefit is received because of the fund or plan and would, as a consequence, be fully included in computing the recipient's income.

Under subsection 139.1(13), conversion benefits are disregarded for the purposes of specific rules in the Act. The effect of subsection 139.1(13) is that:

- where a life insurance policy is registered as an RRSP or a RRIF, a conversion benefit is not considered under paragraph 146(2)(*c*.4) or 146.3(2)(*g*) to be a benefit or advantage that is conditional on the existence of the RRSP or RRIF; and

- a conversion benefit will be disregarded for the purpose of the special rules in subsection 198(6) applicable to the acquisition of a life insurance policy by a trust governed by a DPSP or an RRSP.

Employee-paid Insurance

ITA
139.1(15)

New subsection 139.1(15) of the Act is intended to allow an employer that receives a conversion benefit in respect of a group insurance policy to contribute an amount equal to the value of the conversion benefit to the policy without the contribution being considered an employer contribution. This subsection is applicable with respect to disability and life insurance coverage that is fully employee-funded, and prevents the benefits from becoming taxable by virtue of the contribution. This measure also applies with regard to premiums deemed by subsection 139.1(9) to be paid by the employer in respect of such a policy because of an enhancement of the policy in connection with a demutualization.

Specifically, subsection 139.1(15) applies where the following conditions are met:

- a stakeholder receives a conversion benefit because of the stakeholder's interest in a group insurance policy under which employees are insured;

- employees have borne the full cost of a particular insurance coverage under the policy;

- the stakeholder pays a premium in respect of the particular insurance coverage (whether an actual premium or a premium by operation of subsection 139.1(9); and

- except where the premium was deemed to be paid under subsection 139.1(9), it is reasonable to conclude that the stakeholder intended to apply, for the benefit of the insured employees, all or part of the fair market value of the portion of the conversion benefit that is in respect of the particular insurance coverage.

Where subsection 139.1(15) applies, the premium paid by the stakeholder is deemed to have been paid instead by the insured employees, for the purposes of paragraph 6(1)(*f*) and regulations made under subsection 6(4). Paragraph 6(1)(*f*) includes periodic disability payments in income if they are paid under a plan to which the employer has made a contribution. Regulations made under subsection 6(4) specify the amount of the taxable benefit arising from coverage under a group term life insurance policy. There is no taxable benefit if the life insurance is fully paid for by employees.

Subsection 139.1(15) also provides that the stakeholder is not entitled to deduct a premium to which the subsection applies.

Subsection 139.1(15) also applies to a premium paid under a group insurance policy that provides replacement coverage for the particular insurance coverage that gave rise to the conversion benefit. This rule is intended to accommodate the situation where a new group insurance policy has been entered into, most likely with a different insurer, before the conversion benefit is paid.

Where more than one coverage is provided under a group insurance policy – for example, long term disability and medical and dental benefits – subsection 139.1(15) requires a determination of the extent to which a conversion benefit is attributable to a particular employee-funded coverage. Information for this purpose should be obtained from the insurer.

Flow-through of Conversion Benefits to Employees and Others

ITA
139.1(16)

New subsection 139.1(16) of the Act is generally designed to treat stakeholders (often an employer) as conduits for cash conversion benefits transferred to individuals (often an employee of the employer). This subsection also applies to cases where a stakeholder receives shares on demutualization and payments are made in respect of those shares to individuals.

More specifically, subsection 139.1(16) applies where each of the following conditions is satisfied:

- a stakeholder receives a conversion benefit (referred to as the "relevant conversion benefit") because of the interest of any person in an insurance policy,

- the stakeholder makes a payment of an amount (except, in general, a payment made by way of a transfer of a share) to a particular individual

    - who has received benefits under the policy,

    - who has, or had at any time, an absolute or contingent right to receive benefits under the policy,

    - for whose benefit insurance coverage was provided under the policy, or

    - who received the amount because an individual either received such benefits or had such a right or insurance coverage,

- it is reasonable to conclude that the purpose of the payment is to distribute an amount in respect of the relevant conversion benefit to the particular individual,

- either

  - the main purpose of the policy was to provide retirement benefits or insurance coverage to individuals in respect of their employment with an employer, or

  - all or part of the cost of insurance coverage under the policy had been borne by individuals (other than the stakeholder),

- subsection 139.1(14) does not apply to the relevant conversion benefit, and

- either

  - the particular individual is resident in Canada at the time of the payment, the stakeholder is a person the taxable income of which is exempt from tax under Part I and the payment would, without reference to subsection 139.1(16), be included in computing the income of the particular individual,

  - the payment is received before Announcement Date and the stakeholder elects in writing filed with the Minister of National Revenue, within six months after the end of the taxation year in which the stakeholder receives the relevant conversion benefit (or by such later time as is acceptable to the Minister), that subsection 139.1(16) apply in respect of the payment,

  - the payment is received after [Announcement Date - 1], the payment would, if section 139.1 were read without reference to subsection 139.1(16), be included in computing the income of the particular individual and the stakeholder elects in writing filed with the Minister, on a day that is not more than six months after the end of the taxation year in which the stakeholder receives the conversion benefit (or a later day acceptable to the Minister), that subsection 139.1(16) applies in respect of the payment, or

  - the payment is made after [Announcement Date - 1] and the payment would, if section 139.1 were read without reference to subsection 139.1(16), not be included in computing the income of the particular individual.

In these circumstances, paragraph 139.1(16)(*g*) generally provides that no amount is deductible in computing the stakeholder's income because of the payment. (See, however, the notes below on paragraph 139.1(16)(*l*).)

Under paragraph 139.1(16)(*h*), the particular individual is deemed not to have received the payment, nor is the payment considered to have been payable to the particular individual. Instead, under paragraph 139.1(16)(*i*), the particular individual is deemed to have received a dividend, paid by the corporation that conferred the relevant conversion benefit, equal to the amount of the payment. Paragraph 139.1(16)(*h*) not only ensures that the payment itself is not otherwise included in income (for example, as employment income), but also ensures that a stakeholder's tax-free status under paragraph 149(1)(*i*), (*j*) or (*l*) is not jeopardized by such a payment.

Under paragraph 139.1(16)(*j*), the stakeholder assumes the reporting obligations with regard to the deemed dividend that would otherwise be imposed on the corporation that conferred the relevant conversion benefit.

Under paragraph 139.1(16)(*k*), if the relevant conversion benefit is a taxation conversion benefit, the portion of the benefit in respect of which the payment was made is deemed not to have been received by the stakeholder. However, this measure does not affect the reporting or withholding obligations of the corporation that was deemed to have paid a dividend by virtue of conferring the benefit. In some cases, the payment will be made by a stakeholder before the stakeholder has filed an income tax return for the taxation year in which the dividend was deemed to have been received by the stakeholder. In these circumstances, the Canada Customs and Revenue Agency would be expected to reassess the stakeholder on an appropriate basis to take into account the application of paragraph 139.1(16(*k*).

In some cases, a stakeholder will have received a share as a conversion benefit. In the typical case where this share is not a taxable conversion benefit, the cost amount of the share is deemed to be nil. If the payment made by the stakeholder to the particular individual is in respect of such a share, paragraph 139.1(16)(*l*) provides that the amount of the payment is added to the adjusted cost base of the share (or, if the share has already been disposed of, the

amount of the payment is treated as a capital loss). In the event that the share is not capital property to the stakeholder, paragraph 139.1(16)(*g*) does not apply in respect of the payment with the result that a deduction for the stakeholder in computing the stakeholder's income is not precluded.

New subsection 139.1(16) applies to transactions that occur after December 15, 1998. However, an election referred to above is deemed to have been filed on a timely basis if it is filed not more than six months after the end of the month in which these amendments receive Royal Assent.

Flow-through of Share Benefits to Employees and Others

ITA
139.1(17)

Subsection 139.1(17) of the Act is designed to allow, in some cases, for a rollover from a stakeholder (often an employer) to an individual (often an employee of the stakeholder) of a share received by the stakeholder as a conversion benefit. The conditions for subsection 139.1(17) to apply are identical to the conditions for subsection 139.1(16) to apply, except that subsection 139.1(17) deals with the transfer of a share that was received as a conversion benefit (other than a taxable conversion benefit), rather than a payment (typically a cash payment).

Where subsection 139.1(17) applies, paragraph 139.1(17)(*g*) provides that no amount is deductible in computing the stakeholder's income because of the transfer.

Paragraph 139.1(17)(*h*) provides that the transfer is deemed not to have been made to the individual, nor to represent an amount payable to the particular individual. Paragraph 139.1(17)(*h*) not only ensures that the amount of the transfer itself is not otherwise included in income (for example, as employment income), but also ensures that a stakeholder's tax-free status under paragraph 149(1)(*i*), (*j*) or (*l*) is not jeopardized by such a transfer. However, paragraph 139.1(17)(*h*) does not have any impact on the tax consequences of future transactions or events. In this context, the only relevant future transaction or event typically will be the disposition of the transferred share.

Paragraph 139.1(17)(*i*) provides that the individual is deemed to acquire the transferred shares at a cost equal to nil. This rule is consistent with the nil cost provided under paragraph 139.1(4)(*d*).

New subsection 139.1(17) applies to transactions that occur after December 15, 1998. However, an election referred to above is deemed to have been filed on a timely basis if it is filed not more than six months after the end of the month in which these amendments receive Royal Assent.

Acquisition of Control

ITA
139.1(18)

Subsection 256(7) of the Act sets out rules for determining whether there has been an acquisition of control for the purposes of certain provisions of the Act. In the case of a demutualization of an insurance corporation where policyholders are issued shares for their ownership rights in the corporation, there would be no acquisition of control expected for the purposes of these provisions because of paragraph 256(7)(a) and subsection 256(8.1).

New subsection 139.1(18) provides that, where demutualization of an insurance corporation is effected through the creation of a holding corporation, the acquisition of shares by the holding corporation will similarly not result in an acquisition of control for the purposes of these provisions. More specifically, there will be no acquisition of control because of an acquisition of shares of the insurance corporation by a particular corporation, in connection with the demutualization of the insurance corporation, where immediately after the time that the particular corporation becomes a holding corporation

- the particular corporation is not controlled by any person or group of persons, and

- the total of the "cash" of the particular corporation and the fair market value of the shares of the capital stock of the insurance corporation is not less than 95% of the fair market value of all the assets of the particular corporation. For this purpose, "cash" is comprised of ordinary money (including foreign currency), the

amount of a deposit of such money with a financial institution and the fair market value of specified short-term securities.

Subsection 139.1(18) is modelled on a similar rule in paragraph 256(7)(*e*), but is adapted to apply to the anticipated circumstances where a holding corporation is used in connection with a demutualization.

Mutual Holding Corporations

ITA
139.2

New section 139.2 of the Act sets out the tax treatment of distributions made by a mutual holding corporation, as defined by subsection 139.1(1).

Section 139.2 applies where a mutual holding corporation for an insurance corporation distributes property to policyholders of the insurance corporation. The section provides that the corporation is considered to have paid, and each policyholder is considered to have received, a dividend on shares of the capital stock of the mutual holding corporation. The amount of the dividend received by a policyholder is equal to the fair market value of the property distributed to the policyholder. The most common application of section 139.2 will be with respect to the distribution by a mutual holding corporation of dividends received on shares of the insurance corporation.

Section 139.2 applies to transactions that occur after December 15, 1998.

Clause 39

Deductions in Computing Income

ITA
140(1)

Subsection 140(1) of the Act, in conjunction with subparagraph 138(1)(*a*)(v), allows an insurance corporation a deduction in respect

of the crediting to a policyholder of a dividend or refund of premiums or premium deposits.

Subsection 140(1) is clarified, effective after December 15, 1998, to ensure that the only dividends to which it applies are policy dividends.

Clause 40

Demutualized Insurance Corporations

ITA
141

Section 141 of the Act provides that a life insurance corporation resident in Canada is deemed to be a public corporation. This provision is renumbered as subsection 141(2) and new provisions are added that apply where an insurance corporation has demutualized. These amendments apply after December 15, 1998.

Definitions

ITA
141(1)

New subsection 141(1) of the Act defines "demutualization" and "holding corporation" for the purposes of section 141. Those expressions have the meanings given to them by new subsection 139.1(1).

Holding Corporation Deemed to be Public Corporation

ITA
141(3) and (4)

New subsection 141(3) of the Act applies to a corporation resident in Canada that is a holding corporation in respect of an insurance corporation resident in Canada that has demutualized. It deems the holding corporation to be a public corporation at a particular time if the corporation has a class of shares that meets the conditions relating to the number of shareholders and the dispersal of ownership referred

to in paragraphs 4800(1)(*b*) and (*c*) of the *Income Tax Regulations.* In this context, the reference to "that class" in those paragraphs is intended to refer to any particular class of the capital stock of the corporation (whether or not that class is qualified for distribution to the public). "Holding corporation" is defined in subsection 139.1(1).

Normally, a corporation that does not have any shares listed on a Canadian stock exchange cannot become a public corporation unless a class of its shares is qualified for distribution to the public. Subsection 141(3) eliminates this condition for a holding corporation in respect of a demutualization and it also eliminates the need to make an election to be a public corporation.

Subsection 141(3) applies only during the period specified in new subsection 141(4). The specified period for a corporation starts when it became a holding corporation, and ends when it becomes a public corporation because of any other provision of the Act.

Exclusion from Taxable Canadian Property

ITA
141(5)

New subsection 141(5) of the Act contains a rule that is generally intended, for a temporary period pending the anticipated listing of shares of a resident insurance corporation or its holding corporation on a prescribed stock exchange, to exclude shares issued by those corporations from taxable Canadian property. Consequently, a non-resident shareholder's gain from disposing of such shares will not be taxable in Canada, even though the shares are not listed on a prescribed stock exchange at the time of the disposition.

Subsection 141(5) applies for the purpose of subparagraph 115(1)(*b*)(iv), which provides that a share of a corporation resident in Canada (other than a mutual fund corporation) is taxable Canadian property unless the share is listed on a prescribed stock exchange. Subsection 141(5) deems certain shares to be listed on a prescribed stock exchange.

More specifically, subsection 141(5) applies to a class of shares of an insurance corporation that has demutualized if the corporation has a class of shares that meets the conditions relating to the number of

shareholders and the dispersal of ownership referred to in paragraphs 4800(1)(*b*) and (*c*) of the Regulations. In this context, the reference to "that class" in those paragraphs is intended to refer to any particular class of the capital stock of the corporation (whether or not that class is qualified for distribution to the public). The subsection also applies to the shares of a holding corporation in respect of the insurance corporation if the holding corporation is deemed by new subsection 141(3) to be a public corporation.

Subsection 141(5) applies for a maximum of six months after a demutualization occurs. It does not apply to the shares of a corporation at a time when any shares of the corporation are listed on a stock exchange.

Clause 43

RPP Annuity Contract

ITA
147.4

Section 147.4 of the Act provides a set of rules primarily dealing with individuals acquiring ownership of annuity contracts in satisfaction of their entitlement to benefits under a registered pension plan.

Deemed Proceeds of Disposition

ITA
147.4(2)

Subsection 147.4(2) of the Act contains rules relating to amendments to annuity contracts to which subsection 147.4(1) or paragraph 254(*a*) applies. The rules generally apply if the rights provided for under the contract are materially altered as a consequence of the amendment. In such a case, an individual with an interest in the contract immediately before the amendment is deemed to have received an amount from a pension plan equal to the fair market value of that interest. By virtue of paragraph 56(1)(*a*), the individual is required to include this amount in income. From that point on, the regular provisions for the taxation of annuity contracts apply.

Subsection 147.4(2) is amended so that the rules do not apply to an amendment the sole effect of which is to enhance benefits under an annuity contract in connection with the demutualization of an insurance corporation that is considered for the purposes of section 139.1 to have been a party to the annuity contract. (Note, in this regard, new paragraph 139.1(3)(*h*) under which an insurer assuming obligations under an insurance policy is treated as a party to the insurance policy.)

This amendment applies to annuity amendments that occur after December 15, 1998.

Special Rules for Certain Policies

ITA
147.4(3)

Subsection 147.4(3) of the Act contains rules relating to annuity contracts that replace annuity contracts to which subsection 147.4(1) or paragraph 254(*a*) applies. As long as the rights provided for under the new contract are not materially different from those provided for under the original contract, the new contract is considered to be the same contract as the original contract. As a result, any annuity payments received under the new contract will be treated as superannuation or pension benefits by virtue of paragraph 147.4(1)(*g*) or 254(*a*).

Paragraph 147.4(3)(*a*) is amended to apply the continuation rule in connection with materially different rights under the new contract, where those rights are materially different only because of an enhancement of benefits that can reasonably be considered to have been provided solely in connection with the demutualization of an insurance corporation that is considered for the purposes of section 139.1 to have been a party to the annuity contract. (Note, in this regard, new paragraph 139.1(3)(*h*) under which an insurer assuming obligations under an insurance policy is treated as a party to the insurance policy.)

This amendment applies to annuity substitutions that occur after December 15, 1998.

Clause 64

Application

ITA
212.2

New section 212.2 of the Act is an anti-avoidance rule designed, in the context of the demutualization of insurance corporations, to discourage transactions designed to allow Canadian corporate surplus to be distributed to non-residents free of tax under Part XIII.

> ***EXAMPLE***
>
> *Holdco owns 90% of the shares of Insurco. Insurco issues shares to a non-resident policyholder on a demutualization. Rather than Insurco redeeming the share, Holdco buys the shares and several days later uses dividends received from Insurco to fund the purchase price.*
>
> *If Insurco had redeemed the share, there would have been a deemed dividend equal to the amount of the proceeds of redemption. By having Holdco buy the shares, the deemed dividend rules are avoided. Dividends received from Insurco in this example would be received on a tax-free basis because of the intercorporate dividend deduction.*

Section 212.2 applies where each of the following conditions is satisfied:

- a taxpayer at a particular time disposes of a share of the capital stock of a corporation resident in Canada (or any property more than 10% of the fair market value of which can be attributed to shares of the capital stock of corporations resident in Canada) to a person (referred to below as the "specified person") or partnership (referred to below as the "specified partnership") where:

    (i) the specified person is resident in Canada,

    (ii) any person resident in Canada has, directly or indirectly, an interest in the specified partnership, or

(iii) the acquisition by the specified person or specified partnership is in the course of carrying on a business through a permanent establishment in Canada;

- subsection 212.1(1) does not apply to the disposition;

- the taxpayer is non-resident at the particular time;

- it is reasonable to conclude that the disposition is part of an expected series of transactions or events that includes the issue on its demutualization after December 15, 1998 of a particular share of the capital stock of a particular insurance corporation resident in Canada and

  (i) after the particular time, the redemption, acquisition or cancellation of the particular share, or a share substituted for the particular share, by the particular corporation or the issuer of the substituted share, as the case may be,

  (ii) after the particular time, an increase in the level of dividends declared or paid on the particular share or a share substituted for the particular share, or

  (iii) the acquisition, at or after the particular time, of the particular share or a share substituted for the particular share by

    (A) a person not dealing at arm's length with the particular corporation or with the issuer of the substituted share, as the case may be, or

    (B) a partnership any direct or indirect interest in which is held by a person not dealing at arm's length with the particular corporation or with the issuer of the substituted share, as the case may be; and

- at the particular time, the specified person or any person who has, directly or indirectly, an interest in the specified partnership knew, or ought reasonably to have known, of the expected series of transactions or events described above.

Where subsection 212.2(1) applies to the disposition of property by a taxpayer to a specified person or specified partnership, a taxable

dividend is deemed by subsection 212.2(2) to have been paid by the specified person or specified partnership to the taxpayer. For this purpose, the specified person or partnership is deemed to be a corporation resident in Canada. The amount of the dividend is determined with reference to the paid-up capital of shares to which the property relates. In a simple example where subsection 212.2(1) applies in respect of a disposition of a share, the deemed dividend is equal to the amount by which the proceeds of disposition for the share exceed the paid-up capital in respect of the share.

The amount of any deemed dividend in respect of a share or other property resulting from section 212.2 is excluded under amended paragraph (*k*) of the definition "proceeds of disposition" in section 54 from the non-resident taxpayer's proceeds of disposition for the property. This provision is intended to ensure that no double taxation in Canada occurs in connection with the disposition by a non-resident of taxable Canadian property.

Section 212.2 applies after December 15, 1998.

Clause 65

Social Insurance Number

ITA
237

Section 237 of the Act provides for the use of Social Insurance Numbers for income tax purposes.

ITA
237(2) to (4)

Subsection 237(2) of the Act provides that any person making an information return has to make a reasonable effort to obtain the Social Insurance Number or business number of the person or partnership to which the return relates. In addition, the person making the return cannot release this information, except as set out in the subsection.

Subsection 237(2) of the English version of the Act is amended to allow the release of this information, when authorized by the Act.

New subsection 237(3) permits a person to release this information to a related person, where the related person is required to make an information return that requires this information. This amendment is of significance in the context of demutualization, as it permits an insurance corporation to release this information to its holding corporation in connection with the holding corporation's responsibility to report dividends and other amounts payable to persons who were policyholders in respect of the insurance corporation.

New subsection 237(4) provides further circumstances in which this information may be released to another person in the context of a demutualization of an insurance corporation. Specifically, the Social Insurance Number or business number of a particular person or partnership may be released by an insurance corporation to another person where:

- the other person became the holder of a share of the capital stock of the insurance corporation, or of a holding corporation in respect of the insurance corporation, on the share's issuance in connection with the demutualization of the insurance corporation;

- the other person became the holder of the share in the other person's capacity as nominee or agent for the particular person or partnership pursuant to an arrangement established by the insurance corporation or a holding corporation in respect of the insurance corporation; and

- the other person is required, by this Act or the regulations, to make an information return, in respect of the disposition of the share or income from the share, that requires the Social Insurance Number or business number.

These amendments apply on Royal Assent.

Clause 67

Definitions

ITA
248(1)

"insurance policy"

The definition "insurance policy" is introduced in subsection 248(1) of the Act to clarify that an "insurance policy" includes, in all cases, a "life insurance policy". In this regard, it is noted that the expression "life insurance policy" is defined by subsection 138(12) of the Act to include an annuity contract.

This amendment applies after December 15, 1998, the same as for the coming into force of the provisions in new section 139.1 of the Act on the tax consequences of demutualization.

First Nations Taxation

Clause 27

Income Not Earned in a Province

ITA
120(2.2)

New subsection 120(2.2) of the Act provides for a reduction of an individual's federal income tax liability equal to the amount of the individual's tax payable to an Aboriginal government pursuant to a law of that government made in accordance with a tax sharing agreement between that government and the Government of Canada. To ensure that an individual gets the full benefit of the reduction, this reduction is delivered in the form of a deemed payment on account of the individual's federal income tax.

This amendment applies to the 1999 and subsequent taxation years.

Clause 35

Foreign Tax Deduction

ITA
126(7)

"tax for the year otherwise payable under this Part"

Section 126 of the Act allows a taxpayer to deduct a foreign tax credit (FTC) from tax otherwise payable under Part I of the Act. The calculation of the FTC takes into account, among other things, the proportion of the tax otherwise payable that is attributable to the income on which foreign tax has been paid. Given that an individual's federal income tax liability may be reduced by the individual's income tax payable to an Aboriginal government, the description of B in the definition is amended to ensure that that tax reduction, which is delivered under new subsection 120(2.2) of the Act in the form of a deemed payment on account of tax, is reflected in the FTC computation. For more information on the tax reduction in respect of income tax payable to Aboriginal governments, see the commentary on new subsection 120(2.2).

This amendment applies to the 1999 and subsequent taxation years.

This definition is also amended to eliminate the references to section 120.1, which is being repealed as a consequence of the lapsing at the end of 1997 of the forward averaging mechanism.

These latter amendments apply to the 1998 and subsequent taxation years except that, in their application to the 1998 and 1999 taxation years, subclauses 126(1)(*b*)(ii)(A)(I) and (2.1)(*a*)(ii)(A)(I) and subparagraph 126(3)(*b*)(i) are to be read without reference to the expression "computed without reference to paragraph 20(1)(*ww*)".

Clause 44

Assessments

ITA
152(1)

Subsection 152(1) of the Act lists certain refunds and deemed payments of tax that are to be determined in the course of assessing a taxpayer's tax.

ITA
152(1)(*b*)

Paragraph 152(1)(*b*) of the Act refers to the specific provisions under which amounts are deemed to be paid on account of tax. The amendment to this paragraph adds a reference to new subsection 120(2.2) of the Act which is the provision under which an individual's federal income tax liability is reduced by an amount equal to the individual's income tax payable to an Aboriginal government. For more information on this tax reduction, see the commentary on new subsection 120(2.2).

This amendment applies to the 1999 and subsequent taxation years.

ITA
152(4.2)

Subsection 152(4.2) of the Act gives the Minister of National Revenue the discretion to make a reassessment or a redetermination beyond the normal reassessment period when so requested by a taxpayer who is an individual or a testamentary trust. The amendment to paragraph 152(4.2)(*d*) adds a reference to subsection 120(2.2) to enable the Canada Customs and Revenue Agency to make a redetermination of the amount deemed to have been paid on account of the individual's federal income tax in respect of the individual's income tax payable to an Aboriginal government. For more information on this deemed payment on account of tax, see the commentary on new subsection 120(2.2).

This amendment applies to the 1999 and subsequent taxation years.

Clause 45

Instalments

ITA
156.1

Section 156.1 of the Act relieves an individual from the obligation of making tax instalments where the individual's tax payable is below a certain threshold.

ITA
156.1(1)

"net tax owing"

Subsection 156.1(1) of the Act sets out definitions that are relevant in determining whether an individual is exempt from paying instalments of Part I tax for a taxation year. Under the current rules, an exemption is generally provided if the "net tax owing" for the year, or for each of the two preceding years, does not exceed $2,000 ($1,200 for Quebec residents). The amendments to the definition "net tax owing" are strictly consequential on the introduction of subsection 120(2.2) which provides a reduction of an individual's federal income tax liability equal to the amount of the individual's income tax payable to an Aboriginal government. For more information on this tax reduction, see the commentary on new subsection 120(2.2) of the Act.

These amendments apply to the 1999 and subsequent taxation years.

ITA
156.1 (1.1) and (1.3)

Subsection 156.1(1.1) of the Act provides that, for the purposes of the values A and B in the definition "net tax owing", income taxes payable for a taxation year are computed before taking into account the Quebec tax abatement (which is dealt with in subsection 156.1(1.1)). The amendment adds a reference to new subsection 120(2.2) which, like the Quebec tax abatement, is a tax reduction delivered in the form of a deemed payment on account of tax. That subsection provides for a reduction of the federal income tax liability

equal to the income tax payable to an Aboriginal government. For further information on this tax reduction, see the commentary on new subsection 120(2.2).

These amendments apply to the 1999 and subsequent taxation years.

Clause 47

Interest – Limitation

ITA
161(4) and (4.01)

Subsections 161(4) and (4.01) of the Act provide that no interest is charged on deficient income tax instalments where the instalments are made in accordance with a notice sent for this purpose by the Minister of National Revenue. The amount of the instalment indicated on the notice reflects, among other things, the Quebec tax abatement to which an individual may be entitled. This abatement is delivered through an amount deemed to have been paid on account of tax. The amendments to subparagraphs 161(4)(*a*)(ii) and (4.01)(*a*)(ii) add a reference to new subsection 120(2.2) of the Act, which, like the Quebec tax abatement, is an amount deemed to have been paid on account of tax. Subsection 120(2.2) provides for a reduction of the federal income tax liability equal to the income tax payable to an Aboriginal government. For more information on this tax reduction, see the commentary on new subsection 120(2.2) of the Act.

These amendments apply to the 1999 and subsequent taxation years.

Clause 49

Where Partnership Liable to Penalty

ITA
163(2)

Subsection 163(2) of the Act imposes a penalty where a taxpayer knowingly, or in circumstances amounting to gross negligence, participates in or makes a false statement or omission. The penalty is determined with reference to the understatement of tax or the

overstatement of various amounts deemed to be paid on account of tax. Because the penalty is computed by reference to the net federal tax liability (after deducting all relevant tax credits), clauses 163(2)(*a*)(i)(B) and (ii)(B) include a reference to subsection 120(2) under which the Quebec tax abatement is granted. This abatement is delivered through an amount deemed to have been paid on account of tax. The amendments to clauses 163(2)(a)(i)(B) and (ii)(B) add a reference to subsection 120(2.2) of the Act which, like the Quebec tax abatement, is a provision under which an amount is deemed to have been paid on account of tax. This particular subsection provides for a reduction of the federal income tax liability equal to the income tax payable to an Aboriginal government. For more information on this tax reduction, see the commentary on new subsection 120(2.2).

These amendments apply to the 1999 and subsequent taxation years.

Canada Child Tax Benefit

Clause 33

Deemed Overpayment

ITA
122.61(1)

Subsection 122.61(1) of the Act contains the calculation of the Canada Child Tax Benefit (CCTB) that is available to eligible individuals in respect of qualified dependants. This amendment corrects an oversight in the description of the value of F in the formula used to determine the National Child Benefit (NCB) supplement payable under the CCTB. The amendment clarifies than an individual has to be an eligible individual in respect of a qualified dependant at the beginning of a month to be entitled to the NCB supplement in respect of the dependant for that month.

This amendment is deemed to have come into force on June 18, 1998, the day on which the *Budget Implementation Act, 1998*, under which the CCTB formula was enacted, received Royal Assent.